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## FISCAL IMPACT REPORT

ORIGINAL DATE 02/10/14  
 SPONSOR HTRC LAST UPDATED 02/18/14 HB 124/HTRCS  
 SHORT TITLE Home Energy & Water Efficiency Tax Credit SB \_\_\_\_\_  
 ANALYST Dorbecker/Graeser

### REVENUE (dollars in thousands)

| Estimated Revenue |             |             |             |             |             |           | Recurring or Nonrecurring | Fund Affected |
|-------------------|-------------|-------------|-------------|-------------|-------------|-----------|---------------------------|---------------|
| FY15              | FY16        | FY17        | FY18        | FY19        | FY20        | FY21      |                           |               |
| (\$1,010)         | (\$1,830.0) | (\$2,030.0) | (\$2,030.0) | (\$2,030.0) | (\$1,010.0) | (\$200.0) | Recurring                 | General Fund  |

(Parenthesis ( ) Indicate Revenue Decreases)

\*\* This is not a consensus estimate. LFC’s estimate, reported here is largely assumption driven, but based on capacity of the Home Energy Consultant industry in the state.. See “Fiscal Impacts” below for more detail.

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

|              | FY14 | FY15   | FY16   | 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)

EMNRD indicates that they would need one FTE to process up to 1,500 credit applications. This fiscal impact noted above assumes 720 home energy claims and 720 indoor water efficiency tax credit claims per year for the four-year life of the credit.

Relates to SB 16, Water Harvesting Tax Credit and SB 91, Water Catchment Systems Financing District Act

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Energy, Minerals and Natural Resources Department (EMNRD)

Taxation and Revenue Department (TRD)

### SUMMARY

#### Synopsis of Bill

The House Transportation and Corporations Committee substitute for House Bill 124 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.

The bill’s qualification requirements include a taxpayer who is not a dependent of another individual and who makes improvements that increases the energy or indoor water use efficiency of the taxpayer’s primary residence by at least 10 percent. If the improvements increase the use of these resources by at least 10 percent as measured by industry standard software, the Energy, Minerals, and Natural Resources Department (EMNRD) will provide a certificate to the taxpayer indicating the amount of the increase. The taxpayer will be responsible for the costs of the inspection. The credit is non-refundable, but may be carried forward up to four years.

CS/House Bill 124 establishes the following schedule for the home energy, and water efficiency income tax credit to be allowed as follows:

| <b>Energy Efficiency Improvement Percentage</b> | <b>Tax Credit Amount (\$USD)</b> |
|---|----------------------------------|
| Between 10 and less than 20                     | 2,000                            |
| Between 20 and less than 30                     | 2,500                            |
| 30 or more                                      | 3,000                            |

| <b>Indoor Water Usage Efficiency Improvement Percentage</b> | <b>Tax Credit Amount (\$USD)</b> |
|---|----------------------------------|
| Between 20 and less than 30                                 | 400                              |
| Between 30 and less than 40                                 | 500                              |
| Between 40 and less than 50                                 | 600                              |
| 50 or more  | 700                              |

HB 124 further requires the EMNRD promulgate rules and recommendations 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 determine a certification program for home energy assessors.

The bill includes reporting requirements. The Taxation and Revenue Department (TRD) is required to audit records of the home energy, and water efficiency income tax credit to ensure the credit’s effective administration. TRD must also compile an annual report that includes the number of taxpayers approved to receive the tax credit and the aggregate amount of the credits approved. The bill requires the appropriate legislative committees to review the effectiveness and cost of the state graduate employment tax credit every three years, beginning in 2017.

**EFFECTIVE DATE:**

July 1, 2014; applicable for taxable years beginning on or after January 1, 2014 for improvements installed from January 1, 2015 to and including December 31, 2019. This could result in taxpayers, once granted a certificate by EMNRD, amending already filed TY 2014 returns rather than waiting until the regular time for filing TY 2015, 2016, 2017, 2018 or 2019 returns. There will be some carryover of credits from the first year of applied approved credits to income tax liabilities.

**FISCAL IMPLICATIONS**

TRD reports that it does not have the necessary data to complete a precise analysis. The Energy, Minerals, and Natural Resources Department (EMNRD) does not have data on how many homeowners would take advantage of this program. However, EMNRD anticipates that this program will take time to develop based on their experience with other tax credit programs that they manage and because it will require the homeowner to make an initial investment for an energy and water assessment. EMNRD suggests that the same type of homeowners will take advantage of this tax credit as the sustainable building tax credit. Because very little activity is anticipated in tax year 2014, there is a minimal FY2015 fiscal impact. TRD assumes 100 certificates will be issued for both home energy efficiency and indoor water user efficiency in tax year 2015. The number of certificates is expected to grow at the same rate as the sustainable building tax credit in subsequent years. TRD assumes that all of these certificates will be issued to the “between 20 percent and less than 30 percent” category since EMNRD anticipates that this category will be the most popular because it is not the difficult threshold to meet. TRD expects the fiscal impact to be as reported in the following table.

| Estimated Revenue Impact* |         |        |        |         | R or NR** | Fund(s) Affected |
|---------------------------|---------|--------|--------|---------|-----------|------------------|
| FY2014                    | FY2015  | FY2016 | FY2017 | FY2018  |           |                  |
| -                         | Minimal | (300)  | (850)  | (1,100) | R         | General Fund     |

LFC staff do not agree with these 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 this credit, 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. There is substantially greater opportunity for misstatement and outright fraud than for 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 HERS raters and LEED inspectors. At the moment, there are no course offerings leading to either HERS (Home Energy Rating System) or LEED (Leadership in Energy Efficient Design) inspector certification. However, there are 14 certified HERS companies in New Mexico listed on 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. The estimate in the table assumes that 78 percent of the credit would be claimed on the personal income tax return for the year of installation. The fiscal impact reported in the table is based on these assumptions. Please note that the 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 begins for improvements installed beginning January 1, 2015. However, credits granted for improvements installed in early 2015 could be filed with TY 2014 tax returns – particularly if the taxpayer filed for a two-month extension of time to file TY 2014 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.

- (4) Since the bill does not require durable energy efficiency improvements nor is there a cap in aggregate, the provisions of this bill could become a significant state tax shelter. See also a note below that this type of state tax credit without a corresponding federal credit creates a transfer of revenue from the State General Fund to the federal treasury.
- (5) The home weatherization under the 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 that MFA and HSD understand this opportunity, an average of 400 homes a year would become eligible for a credit pursuant to the provisions of this bill. Because the credit is not refundable, it would take the average LIHEAP treated home a number of years to utilize the earned credit.

Unlike the New Mexico Residential Solar Tax Credit (10 percent of documented and approved costs), this credit is not expressed in terms of a percentage of cash outlays. The credit is determined by a percentage improvement in residential energy efficiency. Thus, \$15,000 worth of improvements to home valued at \$500,000 could increase energy efficiency by, perhaps, 20 percent and be eligible for a \$2,000 credit. On the other hand, \$5,000 worth of improvements to a less valuable, older, rural home could produce a 100 percent increase in energy efficiency and be eligible for a \$3,000 credit. However, since the credit is not refundable, it is unlikely that the credit would be utilized to reduce income tax liability to zero within the allowed five-year period.

While the progressive nature of the credit may have some credence in tax policy, the progressive features effectively prohibit an accurate estimate of the number of homeowners in New Mexico that would utilize this credit or the amounts of approved credits that would be claimed in the initial year or any carry-over year..

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 124/HTRCS are clearly counter to the LFC tax policy principles of adequacy, efficiency and equity. There is no cap on this bill's aggregate credit, which is becoming virtual mandatory on tax expenditure bills. Due to the increasing cost of tax expenditures, revenues may be insufficient to cover growing recurring appropriations. Finally, the equity is virtually impossible to determine, since it depends on the size and condition of the homeowner, access to upfront financing to pay the assessor and fund the recommended improvements, the quality of installation of the improvements and the homeowners personal income tax liability in the absence of the credit.

EMNRD anticipates, "... a fiscal impact of \$70,000 for salaries and benefits per year for a staff person to develop and implement this new program. The actual fiscal impact of HB 124 to the General Fund is indeterminate. EMNRD has no knowledge of how many homeowners would take advantage of this credit since they are responsible for the initial inspection and costs associated with this program. There is no cap on the aggregate amount of credits that may be issued in any year."

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.

The bill provides that the tax credit would be applicable to taxable years beginning on or after January 1, 2014 for improvements installed from January 1, 2015 and January 1, 2020. The substitute bill does *not* provide for an explicit sunset date, but the provisions expire for installations after the end of 2019.

## **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 124 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 878,000 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 problems with this credit:

- The fixed dollar 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. The calculation of this metric is, of course, made more difficult because the credit is not-refundable.
- 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 in the windows, 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 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 Regulation and Licensing’s Construction Industries Division, nor by any city or county building inspector.

The New Mexico Mortgage Finance Agency’s (MFA’s) LIHEAP program reports that it costs \$5,000 to weatherize each home treated under the Weatherization Program (See the analysis of HB 104 of this 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, "... CS/HB 124 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.

## RELATIONSHIP

Relates to SB 16, Water Harvesting Tax Credit and SB 91, Water Catchment Systems Financing District Act

## TECHNICAL ISSUES

TRD notes that, "... page 3, subparagraph 2, lines 9-10, the language stating that the taxpayer has to claim the credit within one year conflicts with Section 7-2-12.1 NMSA 1978 which allows a taxpayer three years to claim a rebate or a credit.

TRD also points out three areas where clarification would be needed:

- It is not clear, but it seems that the taxpayer can take the credit only once. This is true regardless of whether they take them both on the first application or they take one intending to further increase efficiency at a later time. Clarification may need to be made by regulation.
- 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, for example "... means the domicile where a person resides for most of the year in New Mexico..."
- Double dipping of tax credits is not prohibited. A claimant may take multiple tax credits for the same expenditures.

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 nascent credit. At minimum, "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. (See "POSSIBLE QUESTIONS" below for two examples of possible definitional problems.

Most of the software available to home energy consultants uses rules of thumb and fairly rough thermal measurements – sufficient for planning and phasing residential improvements to improve energy performance, but not sufficiently accurate to determine whether recommended improvements have been installed competently, and will be durable, and certainly not to determine if the improvements have increased energy efficiency by 16 percent, or 21 percent or 24 percent and if those increases are durable.

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 exotic 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.

### **OTHER SUBSTANTIVE ISSUES**

LFC staff strongly recommends placing a dollar limit on the aggregate annual cost of this credit.

The only clear beneficiaries of the provisions of this bill would be home energy consultants. The bill provides that the inspection and certification fees would be borne by the homeowner and would have to be paid even if the planned improvements were never completed, or if the planned improvements improved the certified energy efficiency by less than 10 percent or the assessor did not meet EMNRD’s standard of competence.

### **ALTERNATIVES**

Use the residential solar energy credit as a drafting base. Tie the credit to the documented costs. Insist that any planned improvements are either installed by a licensed contractor or inspected by a licensed contractor or an approved private building inspector, not just the energy consultant who developed the energy efficiency improvement plan. Ensure that the improvements are durable with an estimated functional life of at least five years. Ensure that renovations or improvements paid for through a government program or non-profit program do not generate claims (double-dipping) for refund. Define some of the critical concepts in the bill. Establish minimum qualifications for the assessors that should include by availability of measuring tools and software, education and on-the-job training and one of the available home energy consultant certificates.

### **POSSIBLE QUESTIONS**

As an example of possible complexities in drafting regulations to implement the provisions of this bill, consider the following:

- Does installing a grey-water system constitute an indoor water efficiency improvement?
- Does installing a rooftop water catchment system used to water plants in an indoor greenhouse constitute an indoor water efficiency improvement?

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