FISCAL IMPACT REPORT

ORIGINAL DATE 1/22/19
SPONSOR McQueen **LAST UPDATED** 3/16/19 **HB** 221/a HENRC

SHORT TITLE Home Energy Efficiency Income Tax Credit **SB**

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY19	**FY20**	**FY21**	**FY22**	**FY23**		
0	0	($1,000.0)	($1,000.0)	($2,000.0)	Recurring	General Fund (PIT)

Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)
Energy, Minerals and Natural Resources Department (EMNRD)

SUMMARY

Synopsis of HENRC Amendment

The House Energy, Environment and Natural Resource Committee amendment to House Bill 221: (1) provides more guidelines to EMNRD in setting rules and performance standards for home energy improvements that now conform to estimates using nationally recognized energy efficiency software; and (2) prohibits credit amounts for improvements paid with federal funds through a federal or state program; (3) delays the initial date of the program to January 1, 2020.

Synopsis of Original Bill

House Bill 221 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 efficiency income tax credit”. The tax credit’s purpose is to increase the efficiency of energy use in existing residences in the state. To be eligible for a home energy efficiency income tax credit, the taxpayer’s improvements must have increased the primary residence’s energy efficiency by at least twenty 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 $2,000 to $4,000, based on the percentage of improved efficiency (see table below).

Energy Efficiency Improvement Percentage	**Tax Credit Amount ($USD)**
At least 20 and less than 30	$2,000
At least 30 and less than 40	$3,000
40 or more	$4,000

For ***credits claimed*** in the period between January 1, 2020 and December 31, 2022, TRD will cap the credit at $1 million annually – presumably based on the calendar year. For credits claimed between January 1, 2023 and December 31, 2024 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. Note: these dates were not changed in the HENRC amendments, but TRD will deny credits for any energy efficiency improvements made prior to January 1, 2020.

A refund will be issued to a taxpayer for any portion of the tax credit that exceeds the taxpayer's income tax liability for that taxable year. Married taxpayers filing separately are allowed half of the tax credit. Taxpayers are required to claim the tax credit for the taxable year in which the home energy efficiency improvements are made and may not claim the credit beyond one year following the end of the calendar year in which the energy efficiency improvements are made.

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-saving improvements. HENRC amendment, however, prohibits any credit for improvements paid for with federal funds, such as the LIHEAP weatherization program.

HB 221 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 efficiency income tax credit. EMNRD is required to establish a certification program for home energy assessors as well as procedures for certifying the increase in energy efficiency of the New Mexico home. EMNRD is also responsible for establishing procedures for measuring ventilation requirements and combustion safety, although these procedures may or may not be an essential part of the inspection to determine increases in energy efficiency. HENRC amendment somewhat clarified this provision to require the assessors to adopt procedures to determine combustion and ventilation safety (but not effectiveness with regard to energy efficiency).

The Taxation and Revenue Department (TRD) will be required to compile annual reports to evaluate the cost (and effectiveness?) of the credit and present this report to the interim Revenue Stabilization and Tax Policy Committee.

Taxpayers may not claim a solar market development credit and this credit in the same year. In the 2015 HB-163, this prohibition was against the business facility rehabilitation credit (7-2-18.4 NMSA 1978).

There is no <u>effective date</u> of this bill. It is assumed the effective date is 90 days after this session ends (June 14, 2019). The provisions of the act apply to taxable years beginning on or after January, 1 2020, per HENRC amendment. One further limitation should be noted: TRD may (and will) deny credits claimed before January 1, 2020, for renovations performed after January 1, 2019.

FISCAL IMPLICATIONS

This bill may be counter to the LFC tax policy principle of adequacy, efficiency, and equity. Due to the increasing cost of tax expenditures, revenues may be insufficient to cover growing recurring appropriations.

Estimating the cost of tax expenditures 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.

TRD expects the following fiscal impact.

Estimated Revenue Impact*					R or NR**	Fund(s) Affected
FY2019	FY2020	FY2021	FY2022	FY2023		
0		($1,000.0)	($1,000.0)	($1,000.0)	R	General Fund

"TRD conferred with EMNRD to estimate uptake. The credit will reach the aggregate cap with approximately 350 applications per year during the enumerated time period. In its analysis of a similar bill in 2016 EMNRD anticipated 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 assessment required by the bill."

LFC staff approximately confirm TRD/EMNRD's assumptions with a small modification. Renovations installed in the course of calendar 2022 will be claimed on personal income tax returns filed by June 2023 for which the cap is $2,000,000. There will be a mix of $2,000 claims and $3,000 claims, with very few $4,000 claims. However, this program will be attractive ~~for beneficiaries of LIHEAP renovations and~~ to relatively wealthy homeowners who can afford the up to $1,000 costs of hiring a certified assessor to do the pre- and post-renovation assessments. TRD and EMNRD believe that 350 applications per year are likely, but that 700 applications are unlikely. Because the statutory cap proposed in this bill is $2,000,000 for the January 1, 2023 through December 31, 2024, LFC has chosen to show the FY 23 costs in the table as the cap amount.

TRD and EMNRD will have to work closely together to administer this program. The costs to the agencies to properly administer the program may be significant.

With the changes to federal personal income tax liabilities included in the Tax Change and Jobs Act that first affects TY2018 tax returns, an unknown proportion of the taxpayers who would qualify for this credit (homeowners) will 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 for itemizers becomes a transfer to the federal treasury.

SIGNIFICANT ISSUES

Existing home owners face cost barriers and lack of objective information to make energy saving retrofit decisions for their homes. HB 212 provides assistance to address existing homes with energy efficiency improvements. 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, as long as that rental unit is the primary residence of a taxpayer. There is no requirement that the individual renting the property must bear the costs of the renovations or of the pre-and post-renovation inspections.
- Other issues detailed below regarding administration of this program jointly by EMNRD and TRD.

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, 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 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 the following: "… there is a fiscal impact for EMNRD staff, software and computer hardware to launch and operate the Home Energy Efficiency Income Tax Credit program. This annual estimated cost is $87,000 for staff to create rules establishing the new program, develop an electronic submission process for applications, certify home energy inspectors, review and certify tax credit applications, and track certifications to ensure cap is not exceeded and program guideline adherence. The estimate is based on staff time of 2,080 hours, at a $41.82 average hourly rate with fringe benefits. These staff resources are required through the end of fiscal year 2025 to effectively steward the new tax credit program. Additionally, $13,000 is an estimated requirement for software and computer hardware needed to launch the program in FY 2020."

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

TECHNICAL ISSUES

TRD notes a number of issues:

> This legislation creates significant technical issues for TRD and EMNRD. Adjudication of credit eligibility will lie with EMNRD; an electronic MOU is necessary to facilitate processing efficacy."
>
> The use of a "disinterested" third party to facilitate inspections creates logistical challenges for the taxpayer, EMNRD, and TRD. To the extent EMNRD can expand other pre-certification programs to include this new credit, many of TRD's technical concerns can be mitigated. However, the structure of the program effectively negates a homeowner engaging in qualifying DIY activities.
>
> Another technical concern of TRD lies in the term "one-time tax credit." The bill has ambiguities that may create problems for TRD in implementation and might also give rise to litigation. It is not clear if the credit is limited to a one-time use per taxpayer, a one-time use per residence, or a one-time use per project completed. While the bill defines "New Mexico home," in part, as the "primary residence of a taxpayer" who claims the credit, taxpayers may change residence. Further, while a married couple filing taxes separately would each be entitled to only half the credit, it is not clear whether the couple, if living separately, would each be entitled to claim a separate credit. Further, the term "residence," as used, could be interpreted as limiting the credit to a New Mexico resident. This would raise constitutional issues under the Privileges & Immunities Clause and perhaps the Commerce Clause and TRD would, therefore, have to determine whether such an interpretation is permissible, or potentially defend that interpretation if challenged.

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 D). 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 E 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 E may need revision to accommodate taxpayer's that are placed in front of the next year's queue."

EMNRD similarly has a concern:

> HB 221 does not provide guidance for rulemaking. Reference to energy efficiency standards, assessor qualifications or life safety standards are not included. [ed Note: HENRC amendment makes reference to ""nationally recognized requirements," or "state or nationally recognized energy efficiency program."] While HB 221 provides requirements for home inspections by a third-party assessor, it does not define a qualified assessor.

LFC staff note this bill might raise constitutional questions because of phrasing in the anti-donation clause of the New Mexico Constitution. Staff provided a memo to the chairs of HAFC, SFC, and HTRC notifying them of concerns more broadly regarding this type of tax treatment.

OTHER SUBSTANTIVE ISSUES

EMNRD notes that there may be benefits to the unusual refundability feature of this bill. "Given that 76 percent of New Mexican households earn under $50,000 per year and thus often cannot fully use tax credits, the refund provision of HB 221 (section 1.F) makes the program accessible to 100 percent of New Mexicans desiring to participate."

LFC staff have a number of concerns, as well.

- 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. 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 and the uncertainty at the margin between a 20 percent and 30 percent improvement will be significant. 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. 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. ~~This may be of particular importance for individuals whose homes have been renovated under the LIHEAP program.~~
- 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.

OTHER SUBSTANTIVE ISSUES

EMNRD notes as follows: "…costs vary for a home inspection by a third-party assessor both prior to and after energy efficiency improvements. The cost can run between $500 and $1,000 for a Home Energy Rating System (HERS), but that is usually applied for new homes. A program called the Home Energy Score was designed in part to provide an accurate but less expensive inspection than HERS; in some places the Home Energy Score is provided for $75 to $100, according to Colorado Energy Office. HB 221 does not clarify which of these two or any other rating system should be used to assess energy efficiency opportunities."

TRD recommends the following metrics to standardize the administration of all tax credits:

1) credits should not be refundable, thereby limiting the State's investment to the economic value created by the taxpayer;
2) credit programs should sunset within five years so the efficacy of the incentive can be evaluated;
3) credits should have carry forward periods not exceeding three years to limit the fiscal expenditure and the term of the program;
4) programs requiring administration through multiple agencies other than TRD should employ E-Systems;
5) applications for tax credits shall be submitted electronically in a form prescribed by the Department; and
6) application for tax credits shall be made within one tax year of eligibility to limit the administrative and fiscal impacts of the expenditure.

POSSIBLE AMENDMENTS

EMNRD suggests the following amendments should be considered:

1) In Section 1.M, define "qualified assessor" as one who is a certified home energy rater, a building performance institute building analyst or a professional engineer.
2) ~~Insert in Section 1.I, "The energy, minerals and natural resources department shall use nationally recognized energy efficiency and life safety standards to adopt rules for the Home Energy Efficiency Income Tax Credit."~~

LFC staff concerns could be addressed as follows:

1) For a number of reasons, these credits should not be refundable;
2) Rather than a fixed dollar amount of credit based on a percentage increase in efficiency, the credit would be more administrable and somewhat more equitable if the credit were phrased as percentage of the overall costs, including the cost of pre- and post-renovation assessment;
3) The assessor should be required to determine if the installed renovations were permanent, durable and the installation competent.
4) the bill should require the assessor qualifications to include being equipped with industry standard hardware, as well as software.
5) The rollover provision in case of denial because of cap problem should be addressed. When a claim is denied because of the cap, there must be a new claim the following tax year. This new claim must be allowed in Section 1 (D).

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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