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ETIA of 2005 and Home Efficiency Improvements

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The Energy Tax Incentives Act of 2005 (ETIA) was signed into law by President Bush on August 8, 2005. The intent behind the legislation is to help provide moneys to individuals and businesses over a 10-year period that would aid in developing an infrastructure to provide for future energy needs.

According to President Bush, “The bill makes an unprecedented commitment to energy conservation and efficiency—an unprecedented commitment. The bill sets higher efficiency standards for federal buildings and for household products. It directs the Department of Transportation to study the potential for sensible improvements in fuel-efficiency standards for cars and trucks and SUVs. It authorizes new funding for research into cutting-edge technologies that will help us do more with less energy.”

The Act contains provisions that apply to individuals’ residences; business property; automobiles; electricity, coal, oil, and gas; and fuel production, to name a few. Additionally, the provisions can be classified as either “energy efficiency” or “energy production.”

To put it mildly, there is a lot of material in this legislation. We will cover the “nuts and bolts” of ETIA in a series of articles that will focus on the provisions that are generally more applicable to the overall accounting community. This first article primarily looks at provisions applicable to individual taxpayers, including the tax credits available for energy conservation improvements that involve alternative energy sources made to an existing residence. The second article will discuss the business tax deductions and credits for construction of new energy-efficient homes, production of energy-efficient products, and the incorporation of energy-efficient business property. The third article will look at the new credit for the eligible production of certain energy-efficient appliances, such as dishwashers, clothes washers, and refrigerators.

Home Improvement Credit

Section 136(a) of the Internal Revenue Code provides that the value of any subsidy given (directly or indirectly) by a public utility to a customer for the purchase or installation of any energy conservation measure is excluded from gross income. An energy conservation measure means any installation or modification designed primarily to reduce consumption of electricity or natural gas or to improve management of the energy demand of a person’s dwelling unit. At present, there is no law allowing a taxpayer (or homeowner) to claim a tax credit on his or her federal income tax return for making energy-efficiency improvements to an existing home.

ETIA added new IRC §25C, which provides a tax credit for those taxpayers making energy-efficient improvements to their homes in 2006 and 2007. That’s right—the provision is only good for two years! The amount of the credit is equal to the sum of 10% of the amount paid or incurred by the taxpayer for the qualified energy expenditure improvements installed (IRC §25C(a)(1)) and 100% of the residential amount of the energy property expenditures paid or incurred by the taxpayer (IRC §25C(a)(2)).

Qualified energy efficiency improvements are defined in IRC §25C(c)(1) as any energy-efficient building envelope component that meets the prescriptive criteria for building envelope components established by the 2000 International Energy Conservation Code and in effect on the date of the enactment (i.e., August 8, 2005). A “building envelope component” is any insulation material or system designed specifically and primarily to reduce the heat loss or gain of a dwelling unit when installed, exterior windows (including skylights) and doors, and any metal roof installed on a dwelling unit—but only if the roof has appropriate pigmented coatings that are designed to reduce the heat gain for a dwelling.

More importantly, according to IRC §25C(c)(1), the building envelope component must be installed in or on a dwelling unit that is located in the United States, owned by the taxpayer as its principal residence, originally placed into service by the taxpayer, and can be expected to remain in use for at least five years. Thus, summer and winter homes and rental units don’t qualify for the credit.

Property used as a taxpayer’s residence is defined in Treas. Reg. §1.121-1(b)(1) to include a houseboat, a house trailer, or a house or apartment the taxpayer is entitled to occupy as a tenant-shareholder in a cooperative housing corporation. In addition, a dwelling unit includes a manufactured home that conforms to Federal Manufactured Home Construction and Safety Standards.

The residential energy property expenditure component of the credit is defined to mean an energy-efficient building property; an advanced main air-circulating fan; or a qualified natural gas, propane, or oil furnace or

hot water boiler. The performance and quality standards prescribed for qualifying expenditures are given in IRC §25C(d)(2) through (5).

Energy-efficient building property includes an electric heat pump water heater, an electric heat pump, a geothermal heat pump, a high-efficiency central air conditioner, and a high-efficiency natural gas, propane, or oil water heater.

In the case of qualified energy property, the labor costs properly allocable to the on-site preparation, assembly, or original installation of the item are included in the expenditure amount. Interestingly, no mention is made about the inclusion of installation costs as part of the energy modification expenditure; however, it is mentioned specifically as includible in the residential energy property expenditures. One can only surmise that the cost of installation is included in both items, but, presumably, Treasury will be called on to provide a definitive answer before the provision expires in two years.

Now for the shocker: The tax credit for the sum of both components has a lifetime limitation of \$500, and this amount is further limited to \$200 for any expenditure on windows. In addition, further limitations are placed on the credit allowed with respect to the residential energy property expenditures. Specifically, the credit is limited to \$50 for any advanced main air-circulating fan; \$150 for a qualified natural gas, propane, or oil furnace or hot water boiler; and \$300 for any item of energy-efficient building property.

As one might expect, there are a few other issues associated with this provision. First, the credit is a nonrefundable credit; a taxpayer must have a tax liability in order to claim the credit. Moreover, the credit can only

offset a taxpayer’s regular tax liability. Therefore, it can’t be offset against any alternative minimum tax liability.

Second, the basis of the property is decreased by the amount of the credit taken by a taxpayer. In light of the \$250,000 per spouse exclusion on the sale of a taxpayer’s principal residence, this adjustment isn’t significant.

Third, IRC §25C holds that two individuals who jointly own property are able to claim a maximum of \$500 on the property, which means each person is eligible to claim \$250 on the property. If the individuals sell the property in 2007 and individually purchase new principal residences, are they each able to claim an additional credit of \$250 for any new energy expenditures? One would think so because they each have a lifetime credit amount of \$500.

As you have probably guessed, Treasury is going to be very busy writing regulations for this as well as many other provisions included in recently enacted tax provisions. In this instance, however, Treasury may want to revisit the regulations for IRC §44C that were effective for tax years 1977 through 1985. There are a lot of similarities in the current and former energy tax legislation. ■

Note: Part of the material for this article came from the MicroMash CPE course “Energy Incentive Tax Act of 2005” by Tony Curatola and Catina Scafidi.

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