

Statement

**On Behalf of the
National Association of Home Builders**

**Committee on Ways and Means
Tax Reform Working Group on Energy**

Energy Tax Provisions Impacting Real Estate

April 12, 2013

Introduction

Founded in 1942, National Association of Home Builders (NAHB) is a federation of more than 800 affiliated state and local building industry associations. NAHB represents more than 140,000 builder and associate members throughout the country, including individuals and firms that construct and supply single-family homes, as well as apartment, condominium, multi-family, commercial and industrial builders, land developers and remodelers.

In 2005, Congress passed the *Energy Policy Act* (P.L. 109-58) and established a number of important tax incentives to promote greater energy efficiency in the built environment – single family, multifamily and commercial homes and buildings. These incentives acted as the only federal-level programs to address energy efficiency in new and existing homes and buildings, with the intent of moving the market towards greater efficiency and the delivery of innovation and technology transfer in building design and practice.

Three of these incentives expire at the end of 2013: the Section 45L New Energy Efficient Home Tax Credit, the Section 25C Qualified Energy Efficiency Improvements Tax Credit, and the Section 179D Energy Efficient Commercial Buildings Deduction. A fourth incentive, the Section 25D Credit for Residential Energy Efficient Property, expires at the end of 2016. As the Committee considers options for tax reform, NAHB appreciates the opportunity to provide some insight into how these existing incentives are used by builders and consumers alike.

Role of the Tax Code in Energy Policy

A key question in tax reform is whether the current system is operating in a fair/efficient manner or if tax incentives distort the market. That is, however, a complicated measurement to gauge: what is fair or distorting may vary depending on whether the focus is on the business or the consumer. For example, some have argued for elimination of all energy and efficiency tax incentives in an effort to let the market determine the direction of costs and savings for consumers. However, from the consumer perspective, families that face tight budgets could be sidelined in this process.

With or without these incentives, some advocates argue in favor of mandates and aggressive energy code requirements for new homes and buildings that will further impair housing affordability. Some of these new and proposed requirements will prove to be very expensive to the consumer and could take a decade or more to recover the investment, a payoff many homeowners will not see as the average homeowner remains in their home for about ten years, while the average home remains in the housing stock for 60 years or more. Further exacerbating the situation, appraisals often inappropriately or inaccurately value energy efficiency and energy-efficient features in homes, creating a financial disincentive for optional energy efficiency upgrades.

The costs associated with building to the latest codes are not insignificant. Moving from the 2009 IECC to the 2012 EICC will save homeowners, on average, \$427 a year in energy costs. This is not an insignificant amount, but to achieve those savings requires an average upfront investment of over \$5,600.

Table 8: 2012 IECC Cost Effectiveness Relative to 2009 IECC

Climate Zone	Annual Energy Savings	Incremental Construction Cost	Simple Payback (yrs)
1	\$206	\$3,224	15.7
2	\$294	\$3,330	11.3
3	\$470	\$7,203	15.3
4	\$410	\$7,091	17.3
5	\$505	\$4,653	9.2
6	\$397	\$6,399	16.1
7	\$609	\$6,465	10.6
8	\$725	\$6,465	8.9
National Weighted Average	\$427	\$5,668	13.3

As shown in the chart above¹, the payback period for the increased investment—as well as the energy savings and increase in construction costs—varies greatly depending on climate zone. The payback period is calculated by simply determining how long it will take the homeowner, based on the annual energy savings, to recoup the additional construction costs. As noted above, on average a homeowner remains in their home for 10 years. Only two climate zones have a payback period under 10 years, and the national average is 13.3 years. While wealthier homeowners may be able to absorb the additional costs and accept the lengthy payback periods, the increase in cost will price out many consumers from the market for newly built homes. Based on a model developed by NAHB that uses Census data, nationally a \$1,000 increase in home price leads to pricing about 232,447 households out of the market for a median-priced new home.²

While new construction must continue to lead the effort in energy efficient design, the latest requirements have such long payback periods that many middle-class American families will be

¹ This analysis was done by the Home Innovation Research Labs, formerly known as the NAHB Research Center, which was established in 1964 as a wholly-owned, independent subsidiary of NAHB.

² <http://www.nahb.org/generic.aspx?genericContentID=40372>

constrained to older, less-efficient homes and buildings.³ The reality is that the oldest, least-efficient homes are the most affordable to families with lower and moderate incomes. Unfortunately, these families also bear the largest burden in energy costs, as a percentage of income. This is where energy tax incentives, such as the section 45L credit for new home construction, can bridge some of the affordability-gap.

The use of the tax code to incentivize energy efficiency in buildings has a long history of bipartisan support. Mandated efficiency requirements are expensive, and ultimately the consumer bears the brunt of those costs because these costs will be passed on to homebuyers. But to really improve home energy efficiency, we must look at the over 95 million rental and owner-occupied homes that were built before modern energy codes in 1991. Without effective tax incentives, those homes will continue to use energy inefficiently and cost the consumer money.

Utilization of the tax code to promote energy efficiency and consumer savings is the most effective opportunity to truly shape an efficiency policy that is not punitive to the housing market as a whole. Many legislators have considered other incentives to stimulate this market – rebate programs, financing assistance, bond programs, etc. – and while these programs can be helpful, tax incentives are the most direct, and efficient, way to encourage energy efficiency. Consumers easily understand tax credits and deductions and because of this are more likely to take advantage of them.

Section 25C – Qualified Energy Efficiency Improvements Tax Credit

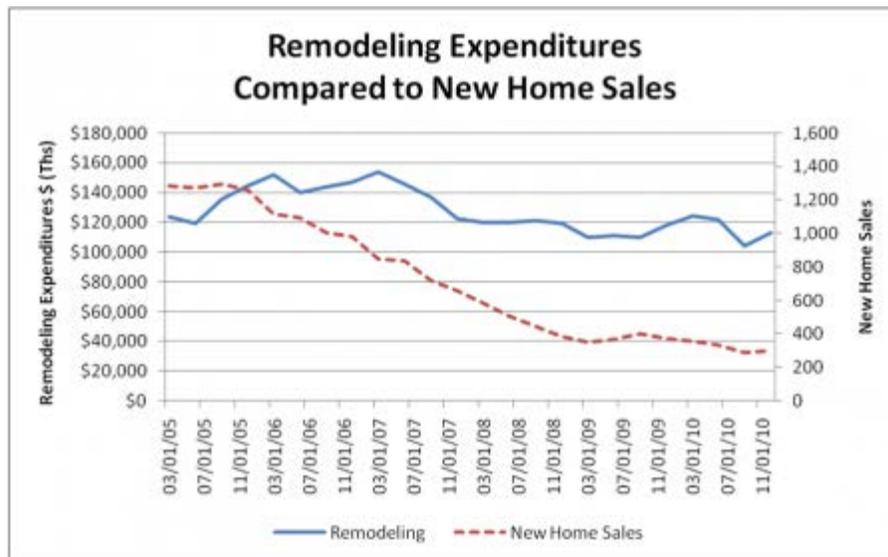
The 25C tax credit began as a modest incentive for the purchase of qualified energy efficiency improvements for existing homes, such as windows, doors, roofs, and HVAC equipment. Originally, the 25C credit provided 10% of the cost of the product (not including installation and labor costs), not to exceed \$500, but imposed various lower caps on specific energy efficient property, such as a maximum of \$200 for window purchases. At the outset, the credit offered little appeal to existing homeowners because the specifications for the qualified improvements had price tags that far exceeded the tax credit. Further, the various caps caused confusion and added complexity. In 2009, the American Reinvestment and Recovery Act (ARRA) expanded the original 25C program and increased the credit to 30% with a \$1,500 cap and included some labor and installation costs. All qualifying products now had the same cap, providing much needed simplicity. As a result, the appeal and popularity of this incentive soared and many retailers, manufacturers, and contractors advertised the newly-enhanced credit which encouraged business and fostered job growth in remodeling activity at the end of 2009 and 2010. For 2011, Congress again extended 25C but reverted the credit back to its lower \$500 cap with various lower caps on certain items.

The success of the credit in those two years is unquestionable. For example, in 2006, 4.3 million taxpayers claimed the 25C and 25D credits. By 2009, that total grew to 6.7 million. Moreover, the IRS data for tax year 2009 also indicates that 25C was heavily used by middle-class homeowners. Of

³ The average age of an owner-occupied home in the U.S. is now 35 years and climbing. See the following NAHB analysis for more detail (“An Aging Housing Stock,” Eye on Housing blog, <http://eyeonhousing.wordpress.com/2012/01/31/an-aging-housing-stock/>)

taxpayers claiming the credit, two-thirds had an adjusted gross income of \$100,000 or less; 93% of taxpayers claiming the credit earned less than \$200,000. Taxpayers in these income classes tend to be very price sensitive, and 25C arguably tipped the scales in favor of energy efficient equipment. Consider a simple window replacement: most homes have an average of twelve windows. Just installing basic windows is a substantial investment; 25C allowed many homeowners to move up to much more efficient windows.

Remodelers often leverage this tax credit when working with clients and will use the credit to promote energy efficient products. In tax year 2009, over \$5 billion of 25C tax credits were claimed. NAHB estimates that these tax credits were claimed in connection with over \$25 billion in remodeling expenditures. These tax credits helped support the remodeling industry (see graph below) during a period in which new home sales experienced dramatic declines. NAHB estimates that the remodeling activity generated by this tax credit in 2009 was associated with over 278,000 full-time jobs. NAHB estimates that every \$100,000 in remodeling expenditures creates enough work for 1.11 full-time equivalent jobs.⁴ The program supported approximately \$13.2 billion in wages for these workers and \$7.5 billion in net business income.



NAHB strongly supports the Section 25C tax credit and believes there are strong policy grounds for making it a permanent part of the tax code. Moving forward, NAHB would also urge Congress to simplify and modernize the new credit by increasing the \$500 cap to \$1,000; allow homeowners to claim installation costs for all eligible products; and remove the confusing lower caps. Adopting this 10% tax credit with a \$1,000 cap will greatly simplify the current tax credit and provide an incentive that middle-class homeowners will continue to utilize to improve the efficiency of their homes.

⁴ THE DIRECT IMPACT OF HOME BUILDING AND REMODELING ON THE U.S. ECONOMY ([HTTP://WWW.NAHB.ORG/GENERIC.ASPX?SECTIONID=734&GENERICCONTENTID=103543&CHANNELID=311](http://www.nahb.org/generic.aspx?sectionid=734&genericcontentid=103543&channelid=311)), NAHB ECONOMICS PAPER.

Section 45L – New Energy Efficient Home Tax Credit

The Section 45L tax credit provides a \$2,000 credit to builders of new (for sale and for lease) homes, of no more than three stories, that exceed a minimum energy code specification and any applicable Federal minimum efficiency standards for equipment by at least 50% in both heating and cooling efficiency. When 45L was renewed as part of the *American Taxpayer Relief Act of 2012*, Congress updated the reference standard from the 2003 International Energy Conservation Code plus the 2004 supplement to the 2006 International Energy Conservation Code. To qualify, the efficiency performance must be independently verified by an authorized energy rater, and the credit is subject to both a basis adjustment and may not be claimed against alternative minimum tax (AMT) liability. Eligible homes include residences, single-family and multifamily, that are sold to owner-occupants or leased for rental purposes.

Although this credit has suffered from start-and-stop issues of short-term and retroactive extensions over the last five years, the 45L program has managed to deliver the market transformation results that Congress intended to encourage. The chart below shows that from enactment the Section 45L credit went from 0.7% of the market in 2006 to 11% of the market for new homes in 2011.

Year	Number of Homes Verified	% of New Homes Sold
2006	7,110	0.7%
2007	23,000	3%
2008	22,000	5%
2009	37,000	10%
2010	21,000	7%
2011	32,000	11%

Data provided by Residential Energy Services Network (www.natresnet.org)⁵

In 2011, 11% of all the new homes sold met the energy thresholds of the Section 45L credit and were 50% or more energy efficient, with a nearly five-fold increase in total certified homes.

The frequent lapses in the credit have proven to be disruptive for builders. The most recent lapse was during 2012. Although Congress has, to date, retroactively approved the credit after every lapse, builders who utilize this tax credit face the difficult decision of whether to continue to offer the benefits of this credit to their customers without knowing if the credit will be extended. This decision is made

⁵ This represents the actual number of homes certified by RESNET, which is the largest certifier. Some additional homes may have qualified through other eligible certifiers.

more difficult due to the ongoing housing depression and incredibly small margins on which most builders currently operate. In fact, the impact of a retroactive extension can likely be linked, in part, to the drop in qualifying homes seen in 2010. In that tax year, all of the tax extenders, including 45L, lapsed for 11 ½ months before Congress extended them retroactively.

Home building is an industry driven by small, often family-owned businesses. According to NAHB's membership survey, approximately 80% of home builders have fewer than 10 employees. Small business owners cannot afford to gamble on whether a tax credit will be extended retroactively. If a builder assumes the credit will not be extended, they may well lose a sale to another builder who assumes it will be and therefore quotes a lower price. The uncertainty created by the recent history of extending these tax provisions retroactively unfairly places small business owners between a rock and hard place. NAHB believes that Congress should not be placing businesses and consumers in the position of guessing the direction of tax policy. Congress has an obligation to create a degree of tax certainty rather than the current situation that leaves businesses to predict the future.

Section 45L is Hampered by AMT Rules and the Basis Adjustment

While claims of the Section 45L credit have grown exponentially, further adoption may be limited by two restrictions imposed under current law. NAHB recommends that Congress enact technical changes to deal with these barriers.

First, the credit cannot be claimed against alternative minimum tax (AMT) liability.⁶ As the home building industry is largely comprised of small builders operating as pass-thrus (80% of NAHB builder members are organized as pass-thru entities), many home builders are trapped in AMT status year after year. Because this credit is claimed by the builder, the AMT limitation effectively deters small builders from participating in the program. NAHB believes that homebuyers and renters will be better served if Congress allows all home builders to take advantage of the Section 45L tax credit by allowing it to be claimed against the AMT.

It is also critical that any AMT fix include a retroactive element that allows "credits determined" to the beginning of the program to be claimed against AMT. For those builders who constructed 45L-eligible homes in good faith but have been unable to claim the credit, a retroactive fix is the fairest approach.

In addition to the AMT, Section 45L(e) requires a basis adjustment by the builder when claiming the tax credit. The basis adjustment poses unique challenges to a builder due to the nature of the home building businesses. Generally, builders may construct homes on a speculative or non-speculative basis. Custom built homes are generally constructed on a non-speculative basis and typically with the eventual homeowner acting as the "builder" (owning the lot and the building materials) and the home builder acting as a general contractor providing the service of construction.

⁶ The *Creating Small Business Jobs Act of 2010* (P.L. 111-240) allowed eligible small businesses to claim general business tax credits, including Section 45L, against the AMT. This applied only to tax credits determined in 2010, so credits earned from 2005 to 2009 that are carried-forward are not eligible for this AMT exemption.

The IRS has taken the position that homes built on a non-speculative basis may not qualify for the program *because the builder does not own the property and therefore cannot reduce basis*. Moreover, IRS Notice 2008-35 makes it clear that the eventual homeowner cannot claim the credit as the “builder” because the 45L credit cannot be claimed for a home in which the taxpayer will reside.

NAHB does not believe that Congress intended to exclude non-speculative homes from the tax credit. The ideal solution would be to eliminate the basis adjustment. Realizing this change would result in a revenue impact, NAHB recommends Congress look to a solution that preserves the basis adjustment while allowing all eligible homes to qualify for the credit.

The commercial energy efficient building deduction, Section 179D also requires a basis adjustment, but allows the deduction to be claimed by someone other than the building owner in certain cases. Specifically, Section 179D(d)(4) authorizes the Secretary to issue regulations to allow the deduction to be claimed by “the person primarily responsible for designing the property in lieu of the owner,” for certain government-owned buildings.

45L could and should be modified to allow the tax credit to be claimed by the general contractor in custom home building, non-speculative building situations (ones in which the owner of the home and lot will be the eventual homeowners, thereby ensuring the tax credit is consistent with its operation as a general business credit under Section 38). This could be accomplished by granting the Secretary authority similar to that under 179D(d)(4). The ultimate fix could then be done via regulation and would not require modifying the existing basis rules.

The basis adjustment requirement also causes a unique conflict for developers of affordable rental housing who are using the Low Income Housing Tax Credit (LIHTC). Because the amount of tax credits a property may receive is determined by a percentage of the project’s basis, a LIHTC developer who claims 45L would face a reduction in eligible Low Income Housing Tax Credits. Because these affordable rental properties operate on strict margins, the basis trade-off makes 45L incompatible with LIHTC development. This is a particular shame because the energy savings would be particularly meaningful to the residents in the affordable units; the LIHTC program serves residents at 60 percent or below the area median income.

Section 25D – Residential Energy Efficient Property

Section 25D provides a nonrefundable 30% tax credit to consumers for the purchase and installation of certain power production property for a home. Typical uses include solar, geothermal, fuel cells, and small wind energy. The credit is uncapped, meaning that all qualified expenses may be claimed. Labor costs are eligible, and unlike Section 25C and Section 45L tax credits, Section 25D credits can be claimed against the AMT.⁷

⁷ Although the tax code does not allow taxpayers to Section 25C credits against the AMT, the annual AMT “patch” typically allows taxpayers to claim Section 25C and other personal, nonrefundable tax credits against AMT.

NAHB believes that the simple, straight-forward approach used in Section 25D should be a model for reforming the Section 25C tax credit. A 30% tax credit that includes labor costs and is automatically AMT-preferred is simple, straightforward and effective. Consumers know exactly what benefit they are receiving, which makes it simpler for them to understand both the tax and energy benefits from switching to an advanced system for heating, cooling, and energy production.

179D - Energy Efficient Commercial Buildings Tax Deduction

Section 179D provides a deduction equal to energy efficient commercial building property expenditures made by the taxpayer. This includes multifamily dwellings built under the commercial building codes (four stories or higher). If a building meets the overall building requirement of a 50% energy savings, the taxpayer may deduct \$1.80 per square foot of the property on which qualifying improvements were made. For buildings that do not reach the targeted energy savings, a partial deduction of \$0.60 per square foot is allowed with respect to each separate building system that meets or exceeds applicable system-specific targets. The taxpayer must obtain an independent certification before the deduction can be claimed.

Unfortunately the deduction is not being used to its full potential. Building industry professionals conclude that the market impact would be far greater with an increase in this benefit along with other changes to make the deduction more usable when retrofitting an older building.

In the 112th Congress, legislation was introduced to modernize the 179 deduction. NAHB hopes that this effort will form the basis for any changes to the incentive. The *Commercial Building Modernization Act* (S.3591), introduced by Senators Jeff Bingaman (D-NM), Olympia Snowe (R-ME), Dianne Feinstein (D-CA) and Ben Cardin (D-MD), sought to provide a more meaningful benefit by increasing the benefit to \$3 per square foot. NAHB believes that this will have a positive effect on the slowly recovering real estate industry and would ease the sticker shock from high initial costs of energy efficient features.

While new construction has benefited from this incentive, the market for renovations has been unable to take advantage of the deduction. Older buildings by default are less efficient than new properties and it is nearly impossible to bring these buildings up to the standards set forth by today's building codes, let alone make them 50% more efficient than the codes. Renovations, however, are incredibly important. 75-85% of existing buildings will still be in use in 2030. By ignoring them, we will never achieve significant energy reductions in the built environment. S. 3591 would have expanded the deduction to target these projects – setting realistic goals that use a performance based approach, comparing a building's performance to its past utility bills, and challenging building owners to push the envelope on energy savings. The bill establishes a sliding scale, which links the amount of the benefit to the amount of energy saved, thus providing motivation to surpass initial energy goals.

The 179D incentive is a very smart way to encourage efficiency. First, it does not choose winners and losers. It offers a product neutral incentive that provides builders and owners the flexibility to select materials and products that are the most cost effective and that best suit their collective needs.

Secondly, it corrects an unintended consequence of the existing tax code. Businesses currently deduct typical operating expenses from their taxes, including utility bills, so the higher the bill, the higher the deduction. In this way, businesses are offered a greater tax benefit for using more energy. The 179D deduction offsets these benefits. By qualifying for the deduction, not only would energy efficiency be incentivized, but these buildings would have lower utility bills, thus reducing the deduction taken for business expenses (energy use).

This particular bill also offered a technical fix that NAHB has long sought to encourage projects developed using the low-income housing tax credit program (LIHTC) to incorporate energy efficiency measures. The 179D deduction requires a basis adjustment, which in turn reduces the amount of LIHTCs that can be used on the property. Because of this, developers have elected not to use the 179D deduction at all. This is unfortunate because those living in these buildings – low-income families – would benefit greatly from lower utility bills. S. 3591 provided that the basis of installed energy efficiency measures would not be reduced for homes financed with the low-income housing tax credits.

S. 3591 is direct, easy to understand and outcome based. NAHB believes that these changes will transform the incentive to ensure greater use and target the largest energy offenders in the built environment. As such, NAHB strongly encourages support for this legislation.

Need for Certainty

Periodically, Congress has allowed several of these incentives to lapse for as long as one year before extending them. While Congress has always provided a retroactive extension, retroactive extensions are particularly problematic for the consumer and small business-oriented tax provisions. In general, these taxpayers are more sensitive to tax uncertainty. Middle-class taxpayers, who are the primary beneficiaries of energy tax incentives, are particularly unlikely to purchase a more expensive, energy efficient product on the expectation that Congress will extend a tax credit retroactively. Likewise, manufacturers are unable to market those products as tax-credit eligible. As a result, when these types of credits are extended retroactively, the “winners” are more likely to have purchased the qualifying product anyway, while middle-class consumers will miss out.

Conclusion

The most effective consumer-focused energy tax incentives have been simple and provided a meaningful incentive to influence consumer behavior. Section 25C and 25D tax credits both offer this straight-forward approach, and particularly in years 2009 and 2010 when Congress provided a simpler, more robust 25C tax credit, it was very effective in reaching the middle class. Although some of these incentives would benefit from updates, nearly all of these tax incentives are performing exactly as Congress intended. Despite the unprecedented downturn in housing and the resultant recession, the increased amount of economic activity associated with the 179D tax deduction for energy efficient commercial buildings and retrofit incentives under 25C, combined with the stellar market penetration of new energy-efficient homes under 45L confirm that federal policies promoting building efficiency are effective, necessary, and accomplish broad conservation goals.