

# Introduction to the Residential Energy Efficiency Property Tax Credit

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## I. Background

In an effort to spur both commercial and consumer uses of renewable energies, Congress passed the Energy Improvement and Extension Act of 2008. Through the act, Congress extended the duration of certain tax credits for renewable energy expenses on residential real estate. As a result, individuals may be credited with thirty percent (30%) of all qualified solar electric, solar water, and small wind energy property expenditures.<sup>i</sup> The credit expires after December 31, 2016.<sup>ii</sup> To help readers better understand how to make use of the credit, this article will set forth some key aspects of the federal law: (1) how tax credits work, (2) what properties qualify for claiming the credit, (3) how to calculate the amount of the credit, and (4) the procedure for claiming the credit.

## II. Tax Credits in General

A tax credit is a one-for-one reduction of the amount of taxes owed. For example, if you owe \$1,000 and have credits that total \$600, your final tax liability is \$400. Tax credits generally are more valuable than equivalent tax deductions since deductions only remove money from your taxable income. For example, suppose Janet is in the 25% tax bracket. A \$1,000 deduction would lower her tax bill by \$250 ( $\$1,000 \times 25\%$ ); a \$1,000 credit would lower her tax bill by the full \$1,000--regardless of tax bracket. Although many tax credits are refundable (i.e. the government pays you for any unused portion), specifically note that the residential renewable energy efficient property credits are nonrefundable.<sup>iii</sup>

## III. Eligible Properties

In order to claim the residential energy efficient property credit, an individual must purchase and install solar electric, solar water heating, or small wind energy property onto "a dwelling unit located in the United States and used as a residence by the taxpayer."<sup>iv</sup> The dwelling in question must be located within the United States (no foreign properties allowed) and used at least some of the time as a residence by the claiming taxpayer. These qualifications specifically do not require that the "dwelling unit" be the "principal residence" of the taxpayer.<sup>v</sup> For example, suppose you live in Austin, Texas for nine months each year and spend the remaining three months living in a home near Galveston. Even though you principally reside in Austin, should you install qualified solar panels on your second home in Galveston, you still may be allowed to claim the tax credit.

Note also that the federal law does not require that the taxpayer own the real estate in order to claim the tax credit. For example, suppose you rent a house in San Antonio to two residential tenants and they want to install a small wind turbine on your property. Assuming you allow such a development, your tenants may be entitled to claim a portion of the expenses as a tax credit. There may be ways of contracting between landlords and environmentally conscious tenants to help bring these renewable energies to the rented property in a way that financially benefits everyone. Be sure to consult with an attorney to plan any such venture.

## IV. Calculating the Credit

The preceding example highlights another intriguing aspect of the tax law: how to calculate the amount of tax credit, especially where multiple parties are involved. As a general matter, thirty percent of all expenditures for residential solar electric, solar water heating, and small wind energy may be credited.<sup>vi</sup>

“Expenditures” includes not only the cost of the equipment, but also any labor costs for things like installation.<sup>vii</sup> For example, if you pay \$16,000 for solar panels and \$4,000 for the cost of labor, federal law allows you to add both costs together to calculate the total expenditure:  $\$16,000 + \$4,000 = \$20,000$ . Thirty percent of the total expenditure then may be taken as a credit against your tax liability: e.g.  $\$20,000 \times 30\% = \$6,000$ . Sometimes these expenditures are made in multiple tax years. Where that occurs, the government only allows the credit to be taken in the year when the original installation of the energy system is completed (i.e. not on subsequent years when, for example, repairs might have been made).<sup>viii</sup>

In cases where two separate taxpayers jointly own the real estate upon which the renewable energy property has been installed, allocation of the appropriate portion of the tax credit may be necessary. However, suppose John and Mary are unmarried but jointly own a house in Corpus Christi that they jointly use as their home. John and Mary each keep separate bank accounts but also maintain a joint account for processing home mortgage payments and, in this example, home repairs and maintenance costs. John and Mary decide to purchase qualified solar panels for their house at a cost of \$10,000. In order to fund the purchase and installation of the solar panels, John deposits \$8,000 in the joint account and Mary deposits \$2,000. John and Mary deliver a check drawn on the joint account to the installer, who proceeds to purchase and install the solar panel system. Although proof of attribution may be somewhat tricky, the core 30% rule still applies. The amount of credit to be allocated in total is \$3,000 (30% of \$10,000), of which John should enjoy a credit of \$2,400

( $\$3,000 \times \$8,000/\$10,000$ ) and Mary should enjoy a credit of \$600 ( $\$3,000 \times \$2,000/\$10,000$ ). This process of allocation allows all investing parties to enjoy the tax benefits of residential renewable energy investment.

## V. Claiming the Credit

The Internal Revenue Service provides Form 5695<sup>ix</sup> for use in claiming the federal residential energy efficient property credit. The IRS provides simple instructions attached to the form for help in preparing simple returns. As you prepare your return, realize that (like all other tax filings) you must be able to prove your expenditures. You will need to prove the amount of your expenditures and that they were for “qualified” energy properties. Concerning proof of the amount, be sure to keep records and/or receipts of monies paid for parts and labor in installation. Concerning proof that whether the property is “qualified”, be sure to request from the installer (or from the manufacturer if you are self-installing) the manufacturer’s certification in writing that a product is qualified residential energy property.<sup>x</sup> Taxpayers should not attach said certification and receipts to the return but should keep those documents for their records in case of future demand by the IRS.

Be aware that, just because you are unable to make use of the tax credit in the appropriate year does not mean that the credit is wasted! As a general rule, unused portions of your tax credit may be carried to the next taxable year and added to the credit allowed for that year.<sup>xi</sup> As a result, even if you cannot use any of tax credit in the tax year in question, always file Form 5695 in the year you finish original installation of your renewable energy property in order that the credit immediately can be carried forward.

This article has not discussed any of the immediate federal tax benefits to installation of commercial renewable energy facilities, which will be focus of an upcoming article.

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## References

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<sup>i</sup> Energy Improvement and Extension Act of 2008, Pub. L. 110-343, § 106(a); 26 U.S.C. 25D(a)(1,2,4).

<sup>ii</sup> 26 U.S.C. 25D(g).

<sup>iii</sup> Energy Policy Act of 2005, Pub. L. 109-58, § 1335(a).

<sup>iv</sup> 26 U.S.C. 25D(d)(1,2,4). Additional credits exist for certain fuel cell and geothermal heat pump properties, albeit they will be addressed in a future article.

<sup>v</sup> Contrast 26 U.S.C. 25D(d)(3).

<sup>vi</sup> 26 U.S.C. 25D(a)(1,2,4).

<sup>vii</sup> 26 U.S.C. 25D(e)(1).

<sup>viii</sup> 26 U.S.C. 25D(e)(8)(a).

<sup>ix</sup> Available at <http://www.irs.gov/pub/irs-pdf/f5695.pdf>. The residential energy efficient property credit may be claimed at Part II of the Form 5695, beginning at line 12.

<sup>x</sup> For purposes of taking the credit, the IRS allows taxpayers to rely on the manufacturer's certification in writing that a product is qualifying property for the credit. See Instructions to Form 5695, page 5.

<sup>xi</sup> 26 U.S.C. 25D(c)(2)(A).