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Leveraging the Energy Efficient Home Credit

A guide for contractors as the deadline approaches

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Background

The Energy Efficient Home Credit (the “45L credit”) provides eligible contractors¹ with a \$2,000 tax credit for each residential unit that meets certain requirements. (Manufactured homes are eligible for a \$1,000 credit.) The program, which began in 2006, was given a one-year extension in 2010 and is now set to expire at the end of 2011. While there has been some discussion of extending the program further, it would be unwise to assume this; contractors who have not taken advantage of this program should plan to do so now.

Eligibility requirements are specified in IRS Notice 2006-27. They include:

- The dwelling can be a freestanding home, townhouse or apartment unit. (Each unit within an apartment complex is eligible for a separate credit).
- The building must stand three stories or less above grade.
- Properties must be substantially completed after August 8, 2005. Dwellings that have undergone substantial renovation and rehabilitation that are completed after this date are also eligible.
- Qualifying properties must be sold or leased during the tax year the credit is being claimed.
- The dwelling must show *at least* a 50 percent reduction in energy consumption compared to other units constructed in accordance with the standards set forth in the 2003 International Energy Conservation Code and 2004 Supplement.
- At least 10 percent of the energy savings associated with heating and cooling must be derived from attributes associated with the building envelope (roof, walls, windows, etc.).

Qualification Requires Preparation

To claim the credit, the contractor must have the unit's energy efficiency certified by an approved rater who has been qualified by the Residential Energy Services Network (RESNET), a national organization that focuses on energy efficiency and related standards for testing, accreditation and reporting. But while the rating of properties under construction is fairly straightforward, the rating of existing properties presents certain challenges because the rater cannot observe materials used during the construction process. For existing properties, if the dwelling underwent local inspection as part of an Energy Star rating or LEED certification, the rater will draw upon that documentation. Intrusive testing also is often done. For example, verification can be done to ensure that the specified insulation has been installed properly in the wall and ceiling cavities. Prior to on-site testing and verification, the rater will also run a computer model as a preliminary test.

Unfortunately, the rater is obligated to give a lower score to factors assessed in existing dwellings to take into account the imperfections in intrusive testing and having to rely on previous documentation. It is not surprising, then, that industry averages suggest that only 25 percent of dwelling units qualify for a 45L credit when assessments are performed on completed projects. Many developers engage third-party

¹ An eligible contractor is the person who constructed the qualified new energy efficient home, or in the case of a qualified new energy efficient home that is a manufactured home, the manufactured home producer of such home.



advisors to help gather documentation, identify shortcomings in the properties to be remediated before inspection and manage the process. Project management fees are typically charged per unit, but only for the units that receive certification.

The overall 45L certification process can be outlined as followed:

- ☐ Background information is gathered for review. At a minimum, this information will include:
 - Exterior building wall composition (outer materials used, wall insulation value and wall construction)
 - Attic insulation composition (blown-in or batt type) and overall installed R-value
 - First-floor slab and/or perimeter insulation installed (if applicable)
 - Windows (manufacturer, sizes, U-value and SHGC [solar heat gain coefficient])
 - Entry door type (wood, insulated steel or insulated fiberglass)
 - Heating and ventilation (HVAC) type and model number installed in or servicing each unit
 - Water heater model number installed in or servicing each unit
 - Year building was built, and the year each unit(s) was/were leased.
- ☐ A preliminary third-party review is conducted, and a proposal for any necessary improvements is submitted to the developer. The information typically used in the preliminary assessment is found in Appendix A.
- ☐ Energy efficiency improvements are made.
- ☐ Contractor engages a RESNET-certified rater, who conducts computer modeling and on-site testing and verification.
- ☐ Contractor receives the certification package, with a complete review of all tested units. The report on units that did not pass includes suggested remedial measures.
- ☐ File IRS Form 8908, claiming the tax credits for qualified units.

Economic Benefits of the Energy Efficient Home Credit

While preparing to qualify for 45L credits is not without cost, the economics are compelling, as these case studies show.

Case Study 1

Completed 65-unit multi-family project, fully leased. This project had four stories, but the first level was below grade, so the client was able to take advantage of 45L on all floors.

In this project 58 of the 65 units passed.

Tax credit (\$2,000 x 58 units)	\$116,000
Project fee (\$450 x 58 units)	\$ 26,100
Net benefit	\$ 89,900

Case Study 2

Completed 244-unit multi-family project, fully leased. This project had three stories.

In this project 162 of the 244 units originally passed. The remedial measures for the units that failed included perimeter foundation insulation and programmable thermostats. By making these changes, an additional 41 passed, bringing the total passed units to 203 units.

Tax credit (\$2,000 x 203 units)	\$406,000
Project fee (\$450 x 203 units)	\$ 91,350
Net benefit	\$314,650



Tax Provisions to Consider

The 45L credit is available to an eligible contractor in the year the certified units/dwellings are leased/sold. For purposes of 45L, a person (i.e., an individual, a trust, an estate, partnership, association, company or corporation) must own and have a basis in the qualified energy efficient home during its construction to qualify as an eligible contractor with respect to the home. For example, if a person who hires a third-party contractor to construct the home owns and has the basis in the home during its construction, the person who hires the third-party contractor is the eligible contractor and the third-party contractor is not an eligible contractor.

The 45L credit also reduces the taxpayer's depreciable basis, and for Section 42 projects, reduces the eligible basis in the property—which could cause a loss in properties receiving Low-Income Tax Credits. An analysis would need to be performed to determine that all credits would be received as expected. Projects best suited for cost segregation studies in the past, including 1602 exchange program projects and market-rate projects, would be excellent candidates for a 45L credit.

Carryforward/Carryback Provisions

The 45L credit is an IRC Section 38 business credit. Normally, this credit has a one-year carryback and a 20-year carryforward, and any portion of the credit that remains unused at the end of the carryover period may be deducted. The general business credits generally (including 45L) are not allowable as a credit to offset Alternative Minimum Tax (AMT). The credit will only be able to offset the excess (if any) of the net income tax for the year over the greater of the tentative minimum tax for the year or 25 percent of the net regular tax liability that exceeds \$25,000. However, any 45L credits considered eligible small business credits (ESBC) determined in 2010 are not subject to AMT limitations and may offset regular and AMT liability.

Clients who cannot use part or all of the general business credit because of the tax liability limit can carry the unused credit back one year (see five-year carryback rule for ESBCs in next paragraph). To carry back an unused credit, the client must file an amended return (Form 1040X, Amended U.S. Individual Income Tax Return 1120X, Amended U.S. Corporation Income Tax Return or other amended return) for the previous tax year or an application for tentative refund (Form 1045, Application for Tentative Refund or Form 1139, Corporation Application for Tentative Refund). Generally, if the client files an application for a tentative refund, it must be filed by the end of the tax year following the tax year in which the credit arose.

To carry back unused ESBCs determined in the first tax year beginning in 2010, the client must file an amended return (Form 1040X, Form 1120X or other amended return) for the previous tax year or an application for tentative refund (Form 1045 or Form 1139). The client must also write "SBJA 2012" at the top of the form used to file the amended return.

ESBCs normally can be carried back five years. However, since the 45L effective date is 2006, they can only be carried back four years. The client will carry back any unused ESBC by reporting it on the 2006 Form 6478, Any carryback of the ESBC not used in 2006 can be carried to 2007 (the next earliest carryback year), and so on, by including any remaining unused ESBCs on the relevant year forms.



If there are any unused credits after carrying it back one year (to each of the four preceding tax years, beginning with the earliest, for ESBCs), the credits are carried forward to each of the 20 tax years after the year of the credit.

Allocation

The 45L credit is apparently not specially allocable and therefore not likely to be separately monetizeable. The general rule for allocating this type of credit is based on the general profit ratio of the partnership. There are two exceptions:

- The credit can be specially allocated only if all related items of income, gain, loss and deductions with respect to the property that gives rise to the credit are specially allocated in the same manner, and
- The special allocation is made in accordance with partner's interest in the partnership or has substantial economic effect.

Because the credit is claimed on the tax return in the year the qualified units were leased or sold, previous year returns can be amended for the credit.

How Reznick Group Can Help

Reznick Group has extensive experience in the commercial real estate industry and in the highly specialized area of tax credits. We offer a range of advisory services designed to help property owners achieve the tax saving benefits associated with "green" energy programs, cost segregation studies and other initiatives.

For more information, please contact Chris Thomas, Principal, at chris.thomas@reznickgroup.com.

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Appendix A: Information Typically Reviewed in Preliminary Assessment of Energy Efficient Home Credit Eligibility

Section A: Insulation Specifications*

Insulation Location	Insulation Thickness	Insulation R-value*	Insulation Type**	Framing (spacing and depth)
Flat ceilings (w/attic above)				
Sloped/cathedral ceilings				
Exterior frame walls				
Rim/Band joists				
Floor over unconditioned basement				
Floor over garage				
Cantilevered floor				
Foundation walls				
Basement frame/walkout walls				
Under-slab insulation				width:
Slab perimeter insulation				depth:

*(Please specify cavity *and* continuous insulation separated by "+").

**If foam insulation is used, specify type (e.g, isocyanurate expanded, extruded polystyrene).

Section B: Door and Window Specifications

Exterior Doors	<input type="checkbox"/> Insulated Steel	<input type="checkbox"/> Fiberglass	<input type="checkbox"/> Wood	<input type="checkbox"/> Other	<input type="checkbox"/> Storm
	Manufacturer	NFRC whole unit U-value	NFRC whole unit SHGC		

Section C: Mechanical Specifications

Heating Equipment	<input type="checkbox"/> Gas	<input type="checkbox"/> Oil	<input type="checkbox"/> Geothermal <input type="checkbox"/> Hydro air <input type="checkbox"/> Open loop <input type="checkbox"/> Closed loop	<input type="checkbox"/> other
	<input type="checkbox"/> Warm air	<input type="checkbox"/> Hot water	<input type="checkbox"/> Radiant floor	<input type="checkbox"/> other
	Gas fireplace	<input type="checkbox"/> Vented	<input type="checkbox"/> Unvented	
	Rated output capacity (BTU/hr or tons):			AFUE or COP rating:
Make:		Model:		

Cooling Equipment	<input type="checkbox"/> Central AC	<input type="checkbox"/> Geothermal	
	Rated output capacity (BTU/hr or tons):		SEER or COP:
	Make:	Model:	
	Make:	Model:	
Make:	Model:		



Domestic Hot Water	<input type="checkbox"/> Gas	<input type="checkbox"/> Oil	<input type="checkbox"/> Electric	<input type="checkbox"/> Geothermal	<input type="checkbox"/> Desuperheater <input type="checkbox"/> Dedicated	<input type="checkbox"/> Solar
	<input type="checkbox"/> Stand Alone	<input type="checkbox"/> Indirect Fired	<input type="checkbox"/> Instant	<input type="checkbox"/> Tankless Coil	<input type="checkbox"/> Other	
	Rated Output Capacity (BTU/hr or tons):				Energy Factor (EF)	
Make:			Model:			

Ventilation System	<input type="checkbox"/> Exhaust-only (rated for continuous operation)		<input type="checkbox"/> Heat recovery ventilator	
Make:		Model:		
Lighting	% Compact fluorescent lightbulbs:		% Pin-based fluorescents:	
Appliances	Dishwasher	Energy factor (EF):		<input type="checkbox"/> ENERGY STAR
	Refrigerator	Kwh/yr:		<input type="checkbox"/> ENERGY STAR
	Stove	<input type="checkbox"/> Gas	<input type="checkbox"/> Electric	<input type="checkbox"/> ENERGY STAR
	Clothes dryer	<input type="checkbox"/> Gas	<input type="checkbox"/> Electric	<input type="checkbox"/> ENERGY STAR
	Ceiling fan	cfm/watt:		<input type="checkbox"/> ENERGY STAR

Section D: Affordable Housing

Number of Units Qualifying as Affordable Housing (40B)	80% AMI:
	60% AMI:

Section E: Renewable Energy

Solar PV	Array area:	Type:	Peak watts:	Direction:	Tilt:
	Inverter efficiency:		<input type="checkbox"/> Commonwealth solar		
Make:		Model:			
Solar Hot Water	Collector area	Type	Direction	Tilt	Storage vol.
Make:		Model:			