



Documents for Podcast 010
Home is Where the Energy Goes—Nonbusiness Energy Property Credit
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The Energy Policy Act of 2005 contains a number of tax incentives for both businesses and consumers. In this podcast, we'll take a look at the credits for nonbusiness energy property found in new IRC §25C.

Nonbusiness Energy Property Credit

A credit of 10% of the price paid will be available for certain energy efficiency improvement property purchased and installed during 2006 and 2007¹ and for “residential energy property expenditures” during those years. The credit is limited to a “lifetime” limitation of \$500 (for the moment the lifetime being limited to the two years the credit is in effect) and further limitations based on the type of property installed.²

Qualified Energy Efficiency Improvements

The term is defined in §25C(c)(1) as:

The term "qualified energy efficiency improvements" means any energy efficient building envelope component which meets the prescriptive criteria for such component established by the 2000 International Energy Conservation Code, as such Code (including supplements)

1 §25C(f)
2 §25C(b)

is in effect on the date of the enactment of this section (or, in the case of a metal roof with appropriate pigmented coatings which meet the Energy Star program requirements), if --

(A) such component is installed in or on a dwelling unit located in the United States and owned and used by the taxpayer as the taxpayer's principal residence (within the meaning of section 121),

(B) the original use of such component commences with the taxpayer, and

(C) such component reasonably can be expected to remain in use for at least 5 years.

Note that the item in question must meet the standards of the 2000 International Energy Conservation Code in effect on the date of enactment of this bill and then must clear three tests:

- Be installed in a property that is both the taxpayer's principal residence (as defined in §121) and which is located in the United States, and
- The use of the property must originate with the taxpayer and
- The component must be reasonably expected to remain in use for at least five years.

These provisions introduce some interesting issues for clients. First, note that the residence in questions will need to be a principal residence for purposes of §121—so a client will need to be careful to be consistent if the taxpayer tries to claim an exclusion under §121 for another residence that he/she was using at the same time as the one that had the property installed.

As well, note that the residence must be both *owned and used* by the taxpayer as the principal residence at the time this transaction takes place—so it will be important to show the expenditure and installation took place after the property had been put to the proper use.

The “original use” language is similar to that we found in the now expired §168(k) bonus depreciation provisions. That means that a used component is not going to work for these purposes, and “rebuilt” or overhauled components could prove to have similar problems as we had under §168(k).

The five year use test is an interesting one, most likely intended to prevent taxpayers from attempting to expand this definition to cover maintenance type expenses (filters and the like) that they might argue meet these standards otherwise. However, this could prove troublesome if the taxpayer subsequently replaces the property in question before the five year period expires—was the component reasonably expected to remain in use for five years when it was installed?

The language does not appear to require, however, that the *taxpayer* be the one to use that property for five years—so selling the property, even the day after the upgrade goes in, does not appear to blow the credit.

As well, CCH notes that some maintenance expenditures (like caulking) that meet the

relevant standards and would be expected to last five years would qualify.

Unlike the next class of items we'll look at, in this case no mention is made of allowing the expense of installation or similar costs. However, it would appear very likely the IRS will view this as meaning Congress did not want this credit to be available for the labor of having these items installed.

The next big problem with the definition is figuring out just what is a "building envelope component" that the Code refers to? The definition of this provision is found at §25C(c)(2):

The term "building envelope component" means --

- (A) any insulation material or system which is specifically and primarily designed to reduce the heat loss or gain of a dwelling unit when installed in or on such dwelling unit,
- (B) exterior windows (including skylights),
- (C) exterior doors, and
- (D) any metal roof installed on a dwelling unit, but only if such roof has appropriate pigmented coatings which are specifically and primarily designed to reduce the heat gain of such dwelling unit.

So what we have is a new term (and likely acronym) for us to bandy about in this area.

One quirk in this half of the credit is that the amount that may be claimed for exterior windows as defined in §25C(c)(3)(B) is limited to \$200. With a 10% credit, that means that the credit maxes out when \$2,000 of expense is incurred.

Residential Energy Property Expenditures

A second class of expenditures is that of "residential energy property expenditures" which is defined at §25C(d)(1)

The term "residential energy property expenditures" means expenditures made by the taxpayer for qualified energy property which is --

- (A) installed on or in connection with a dwelling unit located in the United States and owned and used by the taxpayer as the taxpayer's principal residence (within the meaning of section 121), and
- (B) originally placed in service by the taxpayer.

Such term includes expenditures for labor costs properly allocable to the onsite preparation, assembly, or original installation of the property.

Again, we see the same principal residence test as for energy efficiency improvements. In this case, the property must be originally placed in service by the taxpayer (which is subtly different from the test for energy efficiency improvements), though the property could have been used by someone else previously.

As well, in this case the Code specifically allows for expenses related to the installation

of this equipment.

Again, we have a new term introduced—that of “qualified energy property” which is defined by §25C(d)(2)(A):

The term “qualified energy property” means --
(i) energy-efficient building property,
(ii) a qualified natural gas, propane, or oil furnace or hot water boiler, or
(iii) an advanced main air circulating fan.

As might be clear, the first term needs some further definition. However, they are all subject to the performance and quality standards found at §25C(d)(2)(B) and (C).

The reason why these are broken into three categories is because special limits apply to the credit available for each type of residential energy property expenditure. In order, the limits are

- \$300 for each item defined as energy efficient building property (thus the credit maxes out at \$3,000 of costs incurred)
- \$150 for any qualified natural gas, propane or oil furnace or boiler (maxing out the credit at \$1,500 in costs)
- \$50 for any advanced main air circulating fan (maximum credit hit at a cost of \$500).

We finally get to a detailed list of qualified energy efficient building property (which are eligible for the \$300 maximum credit) in §25C(d)(3), (4) and (5) respectively.

Energy Efficient Building Property is defined at §25C(d)(3) with a list of qualified items. That list contains the following items that meet very specific standards

- Electric heat pump water heater
- Electric heat pump
- Geothermal heat pump
- Central air conditioner
- Natural gas, propane or oil water heater

Special Rules

§25C(e) provides for various special rules and limitations, mainly provided by reference to §25D(e)(4) through (9).

Joint ownership of th residence is covered by §25D(e)(4):

25D(e)(4) DOLLAR AMOUNTS IN CASE OF JOINT OCCUPANCY. --
In the case of any dwelling unit which is jointly occupied and used during any calendar year as a residence by two or more individuals the following rules shall apply:

(4)(A) The amount of the credit allowable, under subsection (a) by reason of expenditures (as the case may be) made during such calendar year by any of such individuals with respect to such dwelling unit shall be determined by treating all of such individuals as 1 taxpayer whose taxable year is such calendar year.

(4)(B) There shall be allowable, with respect to such expenditures to each of such individuals, a credit under subsection (a) for the taxable year in which such calendar year ends in an amount which bears the same ratio to the amount determined under subparagraph (A) as the amount of such expenditures made by such individual during such calendar year bears to the aggregate of such expenditures made by all of such individuals during such calendar year.

Essentially, you aggregate all amounts paid for by all owners and apply the limits on the overall basis, and then any limit are prorated based on the amounts expended by each individual—so if I paid for ½ of the windows with my joint tenant, I would get ½ of the \$200 limit (or \$100) if we had spent at least \$2,000 in total.

§25C(e)(2) itself has a companion provision for joint ownership of the energy items that will end up affecting more than one residence.

25C(e)(2) JOINT OWNERSHIP OF ENERGY ITEMS. --

(A) IN GENERAL. --

Any expenditure otherwise qualifying as an expenditure under this section shall not be treated as failing to so qualify merely because such expenditure was made with respect to two or more dwelling units.

(2)(B) LIMITS APPLIED SEPARATELY. --

In the case of any expenditure described in subparagraph (A), the amount of the credit allowable under subsection (a) shall (subject to paragraph (1)) be computed separately with respect to the amount of the expenditure made for each dwelling unit.

In this case we can get “double” the limits if I and my neighbor get together to do a project that qualifies under one of these provisions.

§25D(d)(5) and (6) provide similar rules for cooperatives and condominium common areas.

(5) TENANT-STOCKHOLDER IN COOPERATIVE HOUSING CORPORATION. --

In the case of an individual who is a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as defined in such section), such individual shall be treated as having made his tenant-stockholder's proportionate share (as defined in section 216(b)(3)) of any expenditures of such corporation.

(6) CONDOMINIUMS. --

(6)(A) IN GENERAL. --

In the case of an individual who is a member of a condominium management association with respect to a condominium which the individual owns, such individual shall be treated as having made the individual's proportionate share of any expenditures of such association.

(6)(B) CONDOMINIUM MANAGEMENT ASSOCIATION. --

For purposes of this paragraph, the term "condominium management association" means an organization which meets the requirements of paragraph (1) of section 528(c) (other than subparagraph (E) thereof) with respect to a condominium project substantially all of the units of which are used as residences.

An interesting observation is that it does not appear that a homeowners' association that did not cover condominiums would qualify. Based on a straight reading of the Code, it appears that a structure owned by a condominium homeowners' association could be improved and qualify for the credit, while the identical structure owned by a homeowners' association would not qualify.

While that does appear to be the result, it also seems the sort of thing that Congress would address in a technical correction at some point, since it seems quite unfair for a standalone clubhouse for a condominium association to qualify the owners for credits, but that same credit be denied to a homeowners' association that owns a similar recreation facility. While Congress could allow the credit in both cases, I would expect the more likely result would be to deny it for both.

Finally, unless more than 80% of the use of the item is for nonbusiness purposes, the expenditure must be allocated between the business and nonbusiness use in order to compute the credit, per §25D(d)(7):

(7) ALLOCATION IN CERTAIN CASES. --

If less than 80 percent of the use of an item is for nonbusiness purposes, only that portion of the expenditures for such item which is properly allocable to use for nonbusiness purposes shall be taken into account.

Basis Adjustment

§25C(f) requires that the basis of the improved property be reduced by the amount of the credit allowed.

Podcast Structure

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