

# Save Energy, Save Money

## Tax Incentives for Energy-Efficient Properties

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**T**he Inflation Reduction Act of 2022, which President Biden signed into law Aug. 16, 2022, could give real estate investors and homeowners even more reason to make their properties energy efficient. Many, if not most, of the provisions in the legislation already existed, but the new law modifies, extends, and expands the tax benefits.

Although the law has been covered abundantly in the news, many might have missed the particulars of the energy incentives. For example, expenditures for construction and improvements to real estate that have energy efficiency benefits can yield significant tax savings. There are also some considerable requirements to qualify.

The level of complexity in the new energy provisions cannot be overstated. The statutory language is not easily understood. A summary booklet published by the Joint Committee on Taxation shows how much mind-numbing detail the 2022 law contains.

The summary lists the law's 25 energy tax provisions and three credit monetization changes, then spends about 100 pages of single-spaced textual narratives to summarize the provisions. The anticipated Treasury Regulations interpreting

### Takeaway

The Inflation Reduction Act of 2022 expands existing tax incentives for individuals and businesses who expend money on energy-saving property. While some of the incentives are likely to result in substantial tax savings, they are complex.

the new laws will no doubt contribute to the breadth and scope of the laws in a manner that will keep tax lawyers and accountants employed for years to come.

The legislation's energy-related tax benefits come primarily in the form of tax credits rather than a tax deduction. Some of the tax credits are designed for individuals and others for business. Tax credits are particularly valuable because they are a direct tax reduction. Every dollar expended that qualifies reduces taxes dollar-for-dollar. A \$1,000 tax credit, for instance, lowers the tax bill by \$1,000.

There are three types of tax credits: nonrefundable, refundable, and partially refundable. Nonrefundable tax credits are amounts directly deducted from an individual's tax liability until the tax due equals \$0. Any amount greater

than the tax owed, which normally results in a refund for the taxpayer, is not paid out as a refund (hence the term “nonrefundable”). Refundable tax credits are the most beneficial because they’re paid out in full. This means a taxpayer (regardless of income or tax liability) is entitled to the entire amount of the credit, beyond a zero amount of tax due. Some tax credits are only partially refundable.

One important feature of the new legislation is the ability to transfer tax credits. Not all taxpayers can use a tax credit, so this feature will open a new area of planning: tax credit transfer planning for potentially qualifying projects.

## Commercial Properties

The new law expands and extends tax deductions (as opposed to tax credits) for expenditures for energy-efficient commercial properties. Generally, the deduction is allowed for depreciable or amortizable property installed on or in a building. The deduction has been substantially increased from \$1.88 to \$5 per square foot. The deduction is available for property installed as part of:

- interior lighting systems;
- heating, cooling, ventilation, and hot water systems; or
- building envelope (the building’s exterior, or anything that separates the property’s conditioned and unconditioned environments).

To qualify for the deduction, the property installed must be certified as part of a plan to reduce the total annual energy and power costs by 25 percent in any of these three categories of expenses.

The credit applies not only to new construction, but also to modifications to existing buildings that reduce the building’s total energy use by at least 25 percent in any of the three categories of expenses listed above. Previously, retrofits had to reduce the building’s energy use by 50 percent.

Another interesting change is the expansion of the credit for buildings constructed for tax-exempt organizations (and native tribal governments and Alaska native corporations). How can an entity that does not pay income tax benefit from a tax credit? The new rules allow the nonprofit incurring the expenditures to allocate the credit to the person primarily responsible for designing the property. This allocation rule raises numerous issues for further consideration, such as defining the responsible party or determining whether the tax-exempt entity can be compensated for the allocable credit.

## Single-Family and Multifamily Homes

A builder is entitled to a \$5,000 tax credit for a qualifying, energy-efficient, new single-family home or \$1,000 to

\$5,000 in tax credits per unit in a new multifamily property. A substantially reconstructed existing single-family or multifamily home that satisfies the standards for energy efficiency is also eligible for the tax credit.

Makers of manufactured homes also qualify for the tax credit. This credit is a continuation of a prior credit and is now extended through 2032, but with new qualification requirements starting in 2023.

Buried in the qualification rules is a requirement that construction labor costs be at the prevailing wage for the location of the residence, as determined by the U.S. Department of Labor.

Special benefits apply to qualified affordable housing. This could result in two tax credits for such properties—one for energy expenses and another for low-income housing.

## Home Improvements

A generous tax credit was already available for home improvements that reduce energy consumption, but the 2022 legislation extended and expanded it for qualifying expenditures placed in 2023 through 2032.

The Energy Efficient Home Improvement Credit increased the tax credit to 30 percent of amounts expended. Homeowners who make qualified energy-efficient improvements to their home after Jan. 1, 2023, may qualify for a tax credit of up to \$3,200 for the tax year in which the improvements are made. Renters, as well as owners of second homes used as residences, may also claim credits. Landlords, however, cannot.

There are three categories of applicable expenditures:

- Expenditures for energy-efficient components in the building envelope, such as windows, doors, skylights, and insulation that satisfies specific standards.
- Expenditures for items that increase energy efficiency, including heat pump water heaters; heat pumps; central air conditioner; and natural gas, propane, or oil water heater or furnace.
- Expenditures for a home energy audit.

Unlike the previous law, which put a lifetime limit on qualifying expenditures, the new law imposes annual limits. The maximum credit that can be claimed each year is:

- \$1,200 (or 30 percent of the amount paid, whichever is less) for energy property costs and certain energy-efficient home improvements, with limits on doors (\$250 per door and \$500 total), windows (\$600) and home energy audits (\$150).
- \$2,000 per year for qualified heat pumps, biomass stoves, or biomass boilers.



Potentially, the maximum total yearly energy efficient home improvement credit amount could be up to \$3,200.

The credit is available for qualifying expenditures to an existing home or for an addition or renovation of an existing home, not for a newly constructed home. The credit is nonrefundable, which means homeowners cannot get back more from the credit than what is owed in taxes, and any excess credit cannot carry over to future tax years.

## Residential Clean Energy Credit

Homeowners who invest in energy improvements for their main home may qualify for an annual Residential Clean Energy Credit, which equals 30 percent of the costs of new, qualified clean energy property installed anytime from 2022 through 2033.

Qualified expenses include those for:

- solar electric property,
- solar water heating property,
- wind turbines,
- geothermal heat pump,
- fuel cells, and
- battery storage technology expenses.

Homeowners may be able to claim a credit for certain improvements other than fuel cell property expenditures made to a second home that they live in part-time and do not rent to others.

The credit has been increased to 30 percent of expenditures for the years 2023 through 2032, and slightly reduced in 2033 and 2034. No credit is available after 2034.

Clean energy equipment must meet the following standards to qualify for the Residential Clean Energy Credit:

- Solar water heaters must be certified by the Solar Rating Certification Corporation or a comparable entity endorsed by the applicable state.
- Geothermal heat pumps must meet Energy Star requirements in effect at the time of purchase.
- Battery storage technology must have a capacity of at least three kilowatt hours.

The credit is available for qualifying expenditures incurred for installing new clean energy property in an existing home or for a newly constructed home. This credit has no annual or lifetime dollar limit, except for fuel cell property. Taxpayers can claim this credit each tax year that they install eligible property until the credit begins to phase out in 2033.

This is a nonrefundable credit, which means the credit amount received cannot exceed the amount owed in tax. Taxpayers can carry forward excess unused credit and apply it to any tax owed in future years.

When it is time to file a tax return, taxpayers can use Form 5695, Residential Energy Credits, to claim the credit. This credit must be claimed for the tax year when the property is installed, not just purchased.

## Transferring Tax Credits

The new legislation permits transfers of credits, but it is subject to restrictions.

- Only certain credits are eligible for transfer.
- Most taxpayers can transfer the credits, but the credits must be transferred to other, unrelated taxpayers.
- The transfer must be paid for in cash.
- Once made, the transferred credit may not be transferred by the transferee.
- The Internal Revenue Service may, as a condition of and prior to any transfer, require information or registration as deemed necessary.

The election to transfer credits cannot have been made before Feb. 12, 2023, and must be made no later than the due date (including extensions of time) for the tax return for the year in which the credit was determined. ♣

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