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FISCAL IMPACT REPORT

ORIGINAL DATE 2/3/2020

SPONSOR Stapleton/Akhil LAST UPDATED 2/8/2020 HB 283/aHENRC

SHORT TITLE Property Tax Of Solar Energy Systems SB _____

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY20	FY21	FY22	FY23	FY24		
		Indeterminate but negative			Recurring	General Obligation Bond revenues
		Indeterminate but moderately negative			Recurring	General Obligation Bond capacity
		Indeterminate but not significant because of the action of yield control			Recurring	County, Muni, School, Hospital & Special District Revenue
		Indeterminate but not significant and dependent on rate setting procedures			Recurring	County, Muni, School, Hospital & Special District GO Bond capacity
		Indeterminate, initially less than 500.0; could grow to 1,000.0 over time			Recurring	Amount of taxes possibly shifted from residential taxpayers with solar systems to those without.

Parenthesis () indicate revenue decreases

SOURCES OF INFORMATION

LFC Files

Responses Received From

Energy, Minerals and Natural Resources (EMNRD)

Responses Not Received From

Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of HENRC Amendments

House Energy, Environment and Natural Resources Committee amendments to House Bill 283 restrict the applicability of the special method of valuing solar property as tangible personal property to leased systems or systems provided under a power purchase agreement. This eliminates from consideration residences with customary home occupations and businesses as being included in the tax consequences of this bill rather than the exemption provisions of 7-36-21.2 NMSA 1978.

Synopsis of Bill

House Bill 283 establishes a new special method of property tax valuation for certain residential solar system installations (but not where the 7-36-21.2 exemption applies). This special method establishes a depreciation schedule that apparently starts with the cost basis of the tangible personal property and adjusts that depreciation by scheduled amounts up to ten years after purchase of the asset.

Depreciation Schedule	Percent of Scheduled Depreciated Value
Year 1 to Year 3	3%
Year 4	4%
Year 5	5%
Year 6	6%
Year 7	8%
Year 8	11%
Year 9	24%
Year 10 et seq.	100%

Section 1 (C) of the bill indicates that the county assessor shall **adjust** the depreciation for a solar energy system ... by the following amounts (as shown in the table above). Section 1 (D) of the bill defines “depreciation” to be straight-line depreciation over the useful life of the item of property. However, estimates of “useful life” for solar systems range from the IRS MACRS class life of 5 years for qualifying solar equipment to 30 years which is the regular class life for residential real property. It is difficult to determine which of these two extremes is meant.

As explained by proponents of this bill, the industry rejects the 5-year bonus life in favor of a ten-year MACRS life. Further, the percentages in the table amount are to be multiplied by the scheduled straight-line depreciation amounts. This results in a net impact table as follows:

Year	Current Year % of value of system	Proposed Accelerated Depr Factor	% System subject to tax
1	95.6%	3.0%	2.87%
2	86.9%	3.0%	2.61%
3	78.1%	3.0%	2.34%
4	69.4%	4.0%	2.78%
5	60.6%	5.0%	3.03%
6	51.9%	6.0%	3.11%
7	43.1%	8.0%	3.45%
8	34.4%	11.0%	3.78%
9	25.6%	24.0%	6.15%
10	16.9%	100.0%	16.88%
11	8.1%	100.0%	8.13%
through	8.1%	100.0%	8.13%
25	8.1%	100.0%	8.13%

Twenty-five years is the usual contract term for these leased/power purchase agreement systems.

In effect, the bill proposes an accelerated depreciation scheme for these systems.

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends (May 20). The special method is applicable to the 2021 and subsequent property tax years. There is no delayed repeal date. LFC recommends a delayed repeal date to allow the legislature to determine if the proposal has achieved the desired results.

FISCAL IMPLICATIONS

This bill may be counter to the LFC tax policy principle of adequacy, efficiency, and equity. Due to the increasing cost of tax expenditures, revenues may be insufficient to cover growing recurring appropriations.

From information in the 2018 edition of TRD’s Tax Expenditure Report, 5,675 residential solar systems were installed between FY2010 and FY2014 at a total five-year expenditure cost of \$11,649,400, which at the 10 percent of cost credit allowance, reflects \$116,494,000 in direct economic activity to solar installers. Extending this analysis through previous editions of the TER, leads to a conclusion that for the period from FY08 through FY17, almost 10,000 claims were processed, representing over \$200 million in investment. Assume that 10 percent of this claim represents business solar – either the proportional amount of depreciation for a solar system for a home office or the full amount of depreciation for installing solar in conventional rental properties. Thus the base of this proposal is on the order of \$2,000,000 per year.

	FY08 - FY17
	Total
Claims	9,963
Expenditures	\$20,444
Average	
Installation	\$20,520
Total Investment	\$204,437,000

The historical popularity of residential solar systems was largely stimulated by the maximum 30 percent federal solar market development credit and the accompanying 10 percent state solar market development credit. The state credit expired December 31, 2016 and the federal credit is scheduled to expire at the end of 2021. This lapse may dampen demand.

According to advocates of this proposal, this proposal would expand access to residential solar and assist in bringing New Mexico’s adoption of leased solar systems up to the standards in other western states. The advocates also point out that *owned* solar systems installed on residences are property tax exempt because of the wording in 7-36-21.2 NMSA 1978 (the 3 percent valuation limitation section). However, leased systems covered by the provisions of this bill would be taxed as business tangible property because the equipment is owned by the solar company.

The proposal “backloads” the tax imposed on the depreciated (and adjusted) value of the property. LFC staff did a conventional net-present-value calculation for the current treatment and for the proposed backloaded treatment. To illustrate the magnitude of the difference in net present value of the taxes, the calculation assumes that the tax basis of the property is \$16,000. The following table illustrates the differences.

	Net Present Value (4% discount rate)	Average Annual Tax Payment (not discounted)
System is owned, not leased (25-year horizon)	\$0	\$0
Leased system -- current treatment (25-year horizon)	\$864	\$44
Leased system -- proposed treatment (25-year horizon)	\$155	\$11

It is difficult to understand why the advocates believe that this property tax proposal would materially affect the number of solar systems installed in the state. Advocates indicate that currently 19 percent of residential solar systems are lease/power purchase units compared to an average of 50 percent in Arizona, Nevada and Colorado.

SIGNIFICANT ISSUES

TRD notes that it is difficult to assess the equity of this proposal:

With access to capital and from a strictly financial standpoint, it is usually more advantageous for a homeowner to own a solar system than to lease one. However, ease and capital limitations can make leasing an attractive option. Much of the advantage of owning the system comes from a large federal tax credit, which is scheduled to be phased out in coming years. Systems that are leased are subject to tangible personal property tax, while systems that are owned increase the residential property tax, subject to a 3% yearly limit. For these reasons, it is difficult to estimate the equitability of the bill between these two choices once the federal ownership credit expires.

The background for the provisions of this bill were discussed in last year’s HB520 relating to the property tax imposed on solar systems. We can distinguish several classes of installations based on ownership and use. These different classes of installations may have differing tax treatment:

	Class	Tax Treatment
1	Solar system installed on an existing residence subject to the 3% annual valuation cap.	7-36-21.2 NMSA 1978 instructs assessor to ignore the value of the solar system for triggering revaluation for physical improvements ¹
2	Solar system installed on new residence.	Presumably, assessor will include value of the solar system in the initial valuation, although some assessors may read 7-36-21.2 NMSA 1978 to allow the value of the solar system to be excluded from the initial assessed value.
3	Sale of a residence with a previously installed solar system.	Presumably, assessor will include value of the solar system in the post-sale valuation although some assessors may read 7-36-21.2 NMSA 1978 to allow the value of the solar system to be excluded from the post-sale valuation.

¹ 7-36-21.2 NMSA 1978 ... This limitation on increases in value does not apply to:

- (1) a residential property in the first tax year that it is valued for property taxation purposes;
- (2) any physical improvements, except for solar energy system installations, made to the property during the year immediately prior to the tax year or omitted in a prior tax year;

4	Solar system installed on residence where there is some business use.	Tangible personal property used in business must be rendered (7-36-33 NMSA 1978), but it would be unusual for a residential solar system to be included on the depreciation schedule for a customary home occupation except in proportion to the home office depreciation.
5	Solar system installed on rental residence, where the owner/lessee is in the business of renting property.	A solar system treated as tangible personal property would have a different MACRS depreciation class life and would have a shorter class life and possible bonus depreciation.

The provisions of this bill seem applicable only to the final two classes in the table -- solar system installed on residence with a business use of a home office and a solar system installed on a rental residence, where the owner/lessee is in the *business* of renting property. This use of depreciation schedules for tangible personal property may mirror recent history of federal support of commercial and industrial solar systems. (See OTHER SIGNIFICANT ISSUES of this review.) HENRC amendment deleted the possibility that solar systems installed on residences with home offices would be forced to render their solar system and pay tax, even with the backloaded factors proposed in this bill.

New Mexico has not successfully solved the conundrum that solar systems might be considered real property, and the legislature can make no exemptions or special methods for real property, only tangible property. Advocates suggest that there are leased systems that are separable and removable from the real property. Thus, the solar system could be considered as tangible property.

As discussed in “OTHER SIGNIFICANT FEATURES,” the federal treatment of solar installations for persons engaged in the business of renting property provides some tax incentives for lessors of real property.

Further background may be useful. From last year’s HB520 ...

The Legislature in HB233 of the 2010 session (2010, ch. 30, § 1) enacted a property tax exemption for the original owner of any solar system. At the time, TRD noted that despite the exemption for the original owner of the solar system, the house would be valued at the sales price when sold. Presumably, the sales price would be higher than for other similar properties because of the installed solar system. What this bill would do is to classify the solar system as tangible property, and thus, the value reported to the assessor would exclude the value of the solar system. This would, presumably, extend the exemption for many years and many subsequent sales of each property.

The provisions of this bill may be somewhat ineffective in excluding the value of a solar system from revaluation to market when a property with an installed solar system changes ownership. According to industry sources, most assessors in the state use CAMA systems. These are computer-aided mass appraisal systems. CAMA systems use data provided by realtors and others to populate a comparable sales database. This database is then used to revalue properties that have sold since the last property tax year valuations were set. The direct report of sales price is probably not used to value the property. CAMA systems do not separately account for the additional value that solar systems give to homes with such systems. All sales are lumped together without differentiation. Thus, in the property tax

world as currently administered, the addition of a solar system does not automatically raise assessed value on sale above the CAMA-determined value.

This bill may be a response to reports that some assessors are separately increasing the assessed value of homes with solar systems on sale outside of the CAMA estimates. In 2010's SB233, which first established a property tax exemption for solar systems when first installed on an existing home, the FIR contains a comment from TRD that when homes with solar systems would sell, the specific nature of the statutory exemption would no longer be effective and the solar system would not be excluded from the revaluation on property sale.

However, there is one clear effect of the provisions of this bill. If a new home is built and a solar system included in the installation, then the exception from the 3 percent valuation cap of 7-36-21.1 NMSA 1978 is not valid. The provisions of this bill would then apply and the assessor could then exclude the cost or value of the solar system from the initial property tax assessment.

It should be noted that the 7-36-21.2 NMSA 1978 exemption did not explicitly define a solar system installed on an existing property as tangible personal property. The legal status is simply that the solar system should not be considered property at all for the purpose of the 3 percent cap on valuation increase.

This bill apparently seeks to reduce a financial disincentive for the installation of a leased solar system on a residence.

Tangible personal property is property taxable if used for industrial or commercial purposes (7-36-20 NMSA 1978). This includes computers, tools, vehicles and other listed items on the business's depreciation schedule. In most cases, the assessor takes that list submitted annually and puts it on the property tax rolls intact, with no modifications.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is not met since TRD is not required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

TECHNICAL ISSUES

The perhaps somewhat hidden purpose of the provisions of this bill is to define a solar system, even if permanently installed on or closely associated with real property, as tangible personal property. This is done in the bill by defining a special valuation method that specifically mentions "SOLAR ENERGY SYSTEM CLASSIFIED AS TANGIBLE PERSONAL PROPERTY." The legislature may propose and enact laws such as this for tangible personal property, but may not enact laws changing any aspect of real property taxation without a constitutional amendment.

1. This bill defines a solar system as tangible property, even when the common standard of real property is generally determined by the six-factor test set forth in *Whiteco Industries*,

Inc. v. Commissioner. Those tests consist of six questions that probe such matters as the nature of affixation, the removability of the asset after fixation and the intent of permanency when installed. The Internal Revenue Code itself does not define “real property,” but rather the working definition is found in the regulations, which include two components: (i) the asset must be deemed permanent (either as a structure or a structural component of such structure) and (ii) it must not be an accessory to the operation of a business.² By any common definition, the six-factor test and the IRS two-components test both rooftop collectors and ground-mount collectors, are real property. As such, it would require a constitutional amendment to overturn the current and correct standard in Article VIII, Section 1, of the New Mexico Constitution.

2. Because this bill redefines tangible personal property and then creates a partial exemption when considered on a year-by-year basis, it may come under the terms of the New Mexico Constitution at Article VIII, Section 3. This section requires a vote of three-fourths of each chamber.
3. With the attention that the provisions of this bill may bring, the exclusion for solar systems from the revaluation triggers of 7-36-21.2 NMSA 1978 into review. An argument could be made that a solar system installed on residential property is not a separate class and thus, the exclusion of solar property on existing homes may violate the equal treatment provision of Article VII, Section 1 of the New Mexico Constitution.

OTHER SUBSTANTIVE ISSUES

MACRS DEPRECIATION³

Normally, 85 percent of the full solar system cost may be depreciated roughly as follows: Year 1 – 20 percent, Year 2 – 32 percent, Year 3 – 19.2 percent, Year 4 – 11.5 percent, Year 5 – 11.5 percent, and Year 6 – 5.8 percent.

For those new to business ownership:

As a large purchase that will be used over time, a solar system’s cost is deducted from taxable income via a so-called 5 year ‘depreciation’ (rather than 100 percent immediately as a direct ‘expense’). While 30 percent of the cost is recovered directly as a credit against tax liability for the year of installation (see above), the law nonetheless allows 85 percent of the full system cost (rather than 70 percent) to be deducted from taxable income over time via ‘depreciation. Depending on the tax bracket, roughly 12-25 percent of original system price may be recouped this way.

BONUS DEPRECIATION

Set to expire at the end of calendar year 2019, there is a bonus depreciation available that allows more of the normal depreciation to occur in the earlier years and thereby encourages solar photovoltaic investment. This bonus is stepped down over the 3 years from 50 percent, to 40 percent for 2018, and finally 30 percent for 2019.

The “basis” upon which depreciation is assessed is 85 percent of a system’s cost. Under the bonus depreciation provisions, for systems “placed in service” by the end of calendar year 2017, 50 percent of the basis – instead of the usual 20 percent, may be depreciated (equating to

² <https://taxlawjournal.columbia.edu/article/tax-matters-vol-4-no-1/defining-real-property-and-its-consequences/>

³ <https://straightupsolar.com/incentives/macrs-bonus-depreciation/>

increasing the depreciable amount of the system’s *entire* cost from 17 percent to 42.5 percent). For systems placed in service by the end of calendar year 2018 the allowable depreciation under the bonus provision is 40 percent of the basis (or 34 percent of *total* system cost). And for systems placed in service by the end of 2019 30 percent is allowed (or 25 percent of *total* system cost).

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy:** Revenue should be adequate to fund needed government services.
2. **Efficiency:** Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity:** Different taxpayers should be treated fairly.
4. **Simplicity:** Collection should be simple and easily understood.
5. **Accountability:** Preferences should be easy to monitor and evaluate

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted:** The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted:** The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent:** The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable:** The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective:** The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions “but for” the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LFC Tax Expenditure Policy Principle	Met?	Comments
Vetted	✘	
Targeted		
Clearly stated purpose	✘	
Long-term goals	✘	
Measurable targets	✘	
Transparent	✘	
Accountable		
Public analysis	✘	

Expiration date	x	
Effective		
Fulfills stated purpose	x	
Passes “but for” test	x	
Efficient	x	
Key: ✓ Met x Not Met ? Unclear		

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