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Investments in income tax credit structures: FAQ

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When – and, if so, how – does the proportional amortization method apply to an investment in an income tax credit structure?

In March 2023, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2023-02, "Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method (a Consensus of the Emerging Issues Task Force)," which broadens application of the proportional amortization method (PAM) of accounting to equity investments in structures beyond those in low-income-housing tax credit (LIHTC) structures. As this will be the first time PAM applies to investments in tax credit programs outside of LIHTC structures, many questions have arisen about whether PAM can be applied and, if so, how to apply it.

As a follow-up to a May 2023 Crowe webinar, the following are insights on some of the more frequently asked questions about ASU 2023-02.

General scope-related questions

1. Can PAM be applied to investments in a tax credit program that are not *equity* investments – for example, to a loan, lease, or other nonequity-related investment in a tax credit program?

No. Application of PAM is limited solely to *equity* investments in income tax credit structures (see Accounting Standards Codification [ASC] 323-740-15-1A). Other forms of involvement with tax credit structures are accounted for under other generally accepted accounting principles (GAAP). For example, a loan extended to a tax credit project is accounted for under Topic 310, "Receivables."

2. Does PAM apply to income tax credits generated from an entity's productive assets?

No. PAM is specific to an entity's *equity* investment in an income tax credit project. Consequently, it does not apply to income tax credits generated from productive assets that are owned or leased by an entity.

The accounting for income tax credits (for example, an investment tax credit or a production tax credit) generated from an entity's productive assets (for example, a qualifying solar energy project) often is within the scope of Topic 740, "Income Taxes." Alternatively, income tax credits might be required to follow a government grant accounting model (for example, ASC 958-605, "Not-For-Profit Entities").[1]

3. For multiple forms of involvement with a tax credit project (for example, an equity investment and a loan), can PAM be applied to the equity investment?

It depends. As noted in Q&A 1, application of PAM is limited to qualifying *equity* investments in tax credit structures. All other forms of involvement would be accounted for under other GAAP.

Importantly, as an investor's level of involvement with a tax credit project increases, so does the likelihood that the investor has either significant influence over or a controlling financial interest in the project. Consequently, if an investor has multiple forms of involvement with a tax credit project, it should carefully assess the level of influence or control it has over the investee when assessing whether PAM can be applied to its equity investment. If the investor is deemed to have significant influence or control over the tax credit project, application of PAM would be prohibited (see Q&A 5 for an example).

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[1] While the scope of ASC 958-605 excludes contributions made by government entities to business entities, regulatory agencies have typically required application of ASC 985-605 by analogy. For example, see the Federal Financial Institutions Examination Council's call report instructions, as well as the Bank Accounting Advisory Series (BAAS) issued by the Office of the Comptroller of Currency (OCC).

4. Can PAM be applied to equity investments in renewable energy tax credit structures?

It depends. To apply PAM to an equity investment in a renewable energy tax credit structure, two conditions must be met. First, the entity must have made an accounting policy election to apply PAM to the related program type. If this is the first time the entity is investing in a certain program type, the election should be made at the date of the investment. Second, the individual investment must meet all five qualifying criteria in ASC 323-740-25-1.

When ASU 2023-02 was issued, many equity investments in renewable energy tax credit structures were priced or structured in a way that they would likely (but not necessarily always) fail the "substantially all" test and/or the "positive yield" test in ASC 323-740-25-1 because many renewable energy structures provide significant non-income-tax-related benefits.

However, if an equity investment in a renewable energy structure does meet both conditions – policy election and all five qualifying criteria – then PAM is applied to that investment.

5. Can PAM be applied to a new markets tax credit (NMTC) structure if an entity holds a controlling financial interest in the community development entity (CDE) and therefore consolidates the CDE in its financial statements?

No. If an entity's equity investment in an NMTC project represents a controlling financial interest in the CDE, then the entity must consolidate the CDE under Topic 810, "Consolidation." PAM applies only to equity investments that do not give rise to a controlling financial interest or significant influence.

6. Upon adoption, does an entity need to reassess whether existing LIHTC investments accounted for under PAM continue to qualify for application of PAM?

Yes. While we would not expect existing LIHTC investments accounted for under PAM to not qualify, there is no "grandfathering" provision in the transition guidance. At a minimum, an entity must make an election to continue to apply PAM to investments in qualifying LIHTC structures.

Policy election questions

Excerpt from the FASB ASC*

ASC 323-740-25-4

The decision to apply the proportional amortization method is an accounting policy decision to be elected on a tax-credit-program-by-tax-credit-program basis that shall be applied consistently to all investments within an elected tax credit program that meet the conditions in paragraph 323-740-25-1 rather than a decision to be applied to individual investments that meet the conditions in paragraph 323-740-25-1.

7. How is the phrase "tax-credit-program-by-tax-credit-program basis" as used in ASC 323-740-25-4 interpreted?

An entity must make an accounting policy election, on a "program-by-program basis," to apply PAM to qualifying equity investments (see Q&A 2) as referenced in ASC 323-740-25-4 and ASU 2023-02.

Entities should apply judgment to determine the appropriate level at which to make the policy election. For example, one entity might elect to not apply PAM to any investment in renewable energy tax credit projects. Alternatively, another entity might decide to apply PAM to qualifying investments in wind tax credit projects but not to any investments in solar tax credit projects. Regardless of the level used to apply the "program-by-program" requirement, an entity should disclose and consistently apply its interpretation.

8. If an entity elects to apply PAM to a certain program, does it still need to assess whether each investment meets the qualifying criteria?

Yes. To apply PAM, two conditions must be met. First, the investment must be in a tax credit program for which an election is made (see Q&A 7). Second, each investment must meet all five qualifying criteria in ASC 323-740-25-1.

In other words, electing to apply PAM to investments in a certain program type (for example, to all investments in NMTC structures) does not negate the requirement to assess whether each individual NMTC equity investment meets all five criteria.

9. Upon adoption, if an entity elects to not apply PAM to equity investments, can the election be changed at a future date?

Yes. The election to apply (or not apply) PAM to equity investments in a specific program type is an accounting policy election. Consequently, if an entity desires to change its accounting policy at a future date, it must apply the guidance in Topic 250, “Accounting Changes and Error Corrections.” In order to make a policy change, an entity must conclude that the change is “preferable.” Entities that are subject to Regulation S-X might also be required to file with the U.S. Securities and Exchange Commission (SEC) a “preferability letter” from the entity’s independent accountant (see ASC 250-10-S99-4).

If an entity changes its accounting policy election, the change should be applied retrospectively to all prior periods, unless it is impracticable to do so.

Qualifying criteria

Excerpt from the FASB ASC*

ASC 323-740-25-1

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met:

a. It is probable that the income tax credits allocable to the investor will be available.

   aa. The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project.

   aaa. Substantially all of the projected benefits are from income tax credits and other income tax benefits (for example, tax benefits generated from the operating losses of the investment). Projected benefits include, but are not limited to, income tax credits, other income tax benefits, and other non-income-tax-related benefits, including refundable tax credits (that is, those tax credits not dependent upon an investor's income tax liability). Tax credits accounted for outside of the scope of Topic 740 (for example, refundable tax credits) shall be included in total projected benefits, but not in income tax credits and other income tax benefits when evaluating this condition. This condition shall be determined on a discounted basis using a discount rate that is consistent with the cash flow assumptions utilized by the investor for the purpose of making a decision to invest in the project.

b. The investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive.

c. The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.

10. How should "substantially all" be interpreted when applying ASC 323-740-25-1(aaa)?

ASC 323-740-25-1(aaa) and ASU 2023-02 do not define "substantially all." In practice, the phrase "substantially all" is commonly interpreted as a 90% threshold (for example, ASC 842-10-55-2(c)). Consequently, it is reasonable to conclude that the "substantially all" criterion is met if the amount of income tax credits and other income tax benefits from the investment exceeds 90% of the investment's overall benefits as determined on a discounted basis.

11. What should be considered when determining the discount rate to use in the "substantially all" test?

ASU 2023-02 does not prescribe the discount rate to be used to apply the "substantially all" test. Instead, it notes the discount rate used should be "consistent with the cash flow assumptions utilized by the investor for the purpose of making a decision to invest in the project." Consequently, an entity should ensure the discount rate used in performing the "substantially all" test is consistent with the cash flow and discount rate assumptions used in its investment decision.

12. How is the "positive yield test" performed under ASC 323-740-25-1(b)?

ASC 323-740-25-1(b) (that is, the "positive yield test") requires a comparison of (a) the amount of undiscounted income tax credits and other income tax benefits expected from the investment to (b) the amount of the initial investment. If (a) is greater than (b), then the positive yield test is met. Otherwise, the criterion is not met, and PAM cannot be applied.

This test considers all income-tax-related benefits, including both federal and state benefits (where applicable). In certain instances, state tax incentives provided as part of an equity investment might not be classified as income tax benefits under ASC 740 and would have to be excluded from part (a) of the test.

13. Should transferable, nonrefundable income tax credits be treated as income tax credits when assessing the criteria in ASC 323-740-25-1 and when applying PAM?

GAAP does not explicitly address the accounting for transferable, nonrefundable income tax credits. Based on discussions with the FASB staff, our understanding is the most appropriate way to account for these types of income tax credits, including the sale of such credits, is to record them within provision for income taxes. However, diversity in practice exists due to the lack of explicit GAAP.

If such credits should be accounted for within ASC 740, the credits should be included in both the numerator and denominator for the "substantially all" test. In contrast, if the credits are outside of ASC 740, then the credits should be included only in the denominator.

14. When calculating other income-tax-related benefits generated from an equity investment, should income-tax-related benefits be reduced by any income-tax-related costs (for example, income tax liability on pass-through taxable income reported to the investor via Schedule K-1) generated from the investment? Or should income-tax-related costs be excluded?

While ASU 2023-02 does not explicitly address the question, our view is income-tax-related benefits should be determined on a net basis – that is, total income-tax-related benefits should be reduced by any income-tax-related costs when a) determining whether an investment qualifies for PAM and b) applying PAM to qualifying equity investments. This view is consistent with how investors generally analyze the total economic effect of the investment.

15. What should be considered when determining whether an entity meets the "significant influence" criterion for applying PAM? How is significant influence assessed when determining whether an equity investment is eligible for PAM?

When applying the "significant influence" criterion in ASC 323-740-25-1, an entity assesses whether it has significant influence over the underlying tax credit project. The assessment is performed consistent with Topic 323, "Investments – Equity Method and Joint Ventures," except that an entity should not consider the quantitative ownership guidance in ASC 323-10-15-8 through 15-11. In other words, for purposes of determining eligibility for PAM, an entity considers solely qualitative indicators of significant influence over the operating and financial policies of the project.

Factors to consider in determining whether an entity has significant influence over the operating or financial policies of a tax credit project include:

- The degree of influence the entity has on the project manager, including kick-out rights and substantive participating rights
- The degree of influence over the project's cash distribution policy
- The degree of influence over the project's capital structure or changes thereto
- Approval rights over the project's operating budget

Other application questions

16. How does the adoption of ASU 2023-02 affect existing LIHTC investments?

In addition to expanding PAM to non-LIHTC investments, ASU 2023-02 makes three changes to Subtopic 323-740 that could affect the accounting for existing LIHTC investments.

First, the ASU removes the “cost method” guidance from Subtopic 323-740. The result is that LIHTC investments that are not accounted for under PAM or the equity method now will be subject to Topic 321, “Investments – Equity Securities” (see Q&A 14).

Second, the ASU removes an example from Subtopic 323-740. The result is that all LIHTC investments now must follow the impairment guidance in Topic 323 rather than using the impairment methodology in the removed example.

Third, the ASU modifies the scope of the delayed equity contribution guidance in Subtopic 323-740. The result is that the delayed equity contribution guidance now applies only if a LIHTC investment is accounted for under PAM. Otherwise, delayed equity contributions are not recognized until funded (consistent with Topic 323).

Because existing LIHTC investments might be affected by these changes, ASU 2023-02 permits transition to the changes on either a prospective basis or consistent with the general transition in ASU 2023-02. The transition method used for each change does not need to be consistent.

17. If an equity investment doesn't qualify for PAM, how should it be accounted for?

If an equity investment does not qualify for PAM – either because the entity has elected to not apply PAM to the program type or the investment does not meet all five qualifying criteria in ASC 323-740-25-1 – the entity should next assess whether it has significant influence over the investee.

Assessment of significant influence for investments that do not qualify for PAM (or for which the entity has elected to not apply PAM) follows the guidance in ASC 323, including consideration of whether the investor has significant influence over the operating and financial policies of the investee. This assessment also should consider the quantitative thresholds in ASC 323-10-15-8 through 15-11. Consequently, if the entity's investment is more than minor – interpreted in practice to mean an investment of greater than 3% to 5% ownership – there is a presumption that the entity has significant influence and therefore the equity method should be used.

If, however, the entity concludes it does not have significant influence (for example, its investment is less than 3% to 5%), the investment should be accounted for under Topic 321 (see Q&A 18).

18. How does an entity account for an equity investment in a tax credit structure under Topic 321?

Equity investments under Topic 321 are accounted for in one of two ways. If the equity investment has a readily determinable fair value,[2] the investment is measured at fair value with changes in fair value recorded through earnings at each reporting period. For equity investments that do not have a readily determinable fair value, the entity can either 1) account for the investment at fair value or 2) elect to account for the investment at cost.

Equity investments initially recorded at cost are subsequently evaluated for impairment. Additionally, when an entity identifies observable price changes for the identical or similar investments, it should evaluate whether to remeasure the investment to its then-current fair value.

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[2] Generally speaking, an equity investment is considered to have a readily determinable fair value if it is traded on an exchange registered with the SEC or in the over-the-counter market with prices publicly reported. For more information, refer to the FASB ASC Master Glossary, "readily determinable fair value."

Learn more

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