Defining Issues®

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FASB Issues Guidance on Investments in Low Income Housing Tax Credits

The FASB issued guidance that will let investors in low income housing tax credit (LIHTC) entities that meet certain conditions account for the investments entirely in income tax expense, which stakeholders believe more accurately reflects the economics of the investments.[1]

Key Facts

- Investors can elect to record the income statement effects of certain investments in LIHTC entities entirely in income tax expense.
- The effective yield method is replaced with the proportional amortization method.[2]
- The guidance is effective for public business entities for annual periods (and interim periods within those annual periods) beginning after December 15, 2014, and for other entities for annual periods beginning after December 15, 2014, and interim periods thereafter. Early adoption is allowed.
- Disclosure must be made for all LIHTC investments, regardless of whether the proportional amortization method is being applied.

Key Impacts

- More investors will be allowed to account for the income statement effects of their investments entirely in income tax expense.
- Because proportionate amortization of the investor's cost and the tax benefits are recognized in current income tax expense when the tax benefits are reflected on the tax return, no deferred taxes will be recognized on the basis difference of the investment.
- Companies have the option to early adopt the new guidance in annual financial statements that have not yet been issued, including December 31, 2013, financial statements.

Contents

[1] FASB Accounting Standards Update (ASU) No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects, available at www.fasb.org.

[2] FASB ASC Section 323-740-35 (formerly EITF No. 94-1, Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects), available at www.fasb.org.

Why Revisit the Accounting for LIHTC Investments?

The LIHTC program was designed to encourage investments in the construction and rehabilitation of low income housing projects. LIHTC investors receive tax credits over 10 years but are subject to a 15-year recapture period.

Low income housing projects typically generate (and pass along to investors) pre-tax losses after considering the effects of depreciation, but the associated tax benefits of those losses, when considered together with the credits, generally result in a positive return to investors.

Previously, investors were allowed to apply the effective yield method if certain conditions were met. Investors applying the effective yield method reported a constant yield on their LIHTC investments entirely through income tax expense over the tax credit period. Those that did not meet the criteria generally applied the equity method of accounting for the investment. Investors applying the equity method reported their share of the project's pre-tax operating losses in pre-tax income and the tax credits and the tax effect of the operating losses in income tax expense.

The EITF decided to revisit the accounting for LIHTC investments because very few investors could meet the conditions to apply the effective yield method and the EITF concluded that application of the equity method did not result in useful financial statement presentation for many LIHTC investments.

How Do I Qualify for the Proportional Amortization Method?

As an accounting policy election, an investor can apply the proportional amortization method if all of the following conditions are met:

(A) It is probable the tax credits will be available;

(B) The investor does not have significant influence over the operating and financial policies of the low income housing project;[3]

(C) Substantially all of the projected benefits of the investment are from the tax credits and other tax benefits;

(D) The investor's expected return is positive, based solely on the cash flows from the tax credits and other tax benefits; and

(E) The investor holds a limited interest (LLP or LLC) in the low income housing project for both legal and tax purposes and its liability is limited to its capital investment.

Condition (B) does not allow an investor with significant influence over the project to apply the proportional amortization method. In evaluating significant influence, the investor considers the indicators listed in ASC Topic 323.[4] However, because that guidance was intended for investments in common stock rather than investments in partnerships, LIHTC investors would not need to presume they have significant influence based on the quantitative guidelines provided for common stock investments.[5] Further, LIHTC investors would not be

[3] FASB ASC paragraph 323-10-15-6, available at www.fasb.org.

[4] FASB ASC Topic 323, Investments—Equity Method and Joint Ventures, specifically paragraphs 323-10-15-8 through 15-11, available at www.fasb.org.

[5] FASB ASC paragraph 323-10-15-8, available at www.fasb.org.

presumed to have significant influence because their ownership interest exceeds the "more than minor" (3-5%) threshold for limited partnership investments in ASC Subtopic 323-30.[6]

Investors will need to evaluate the effect of other relationships with the project on their ability to meet the conditions required to apply the proportional amortization method. However, transactions executed at arm's length in the normal course of business that do not result in the investor obtaining significant influence (e.g., a bank investor extending bank loans to the project entity) would not preclude the conditions from being met.

Investors that do not qualify for the proportional amortization method (or do not elect to apply it) would account for their investments under the equity or cost method using existing U.S. GAAP.

This guidance only applies to LIHTC investments; however, the FASB is considering whether to expand the scope of this guidance (or develop new guidance) for other tax credit investments.

How Do I Apply the Proportional Amortization Method?

Investors applying the proportional amortization method recognize the following three items in current tax expense (benefit):

The cost of the investment is amortized in proportion to (and over the same period as) the total tax benefits expected to be allocated to investors (including credits and other tax benefits generated from the LIHTC project's operating losses). The tax benefits (both credits and deductions) are recognized in current tax expense and no deferred taxes are provided on the basis difference of the investment.[7]

Example 1 – Applying the Proportional Amortization Method

SaveRite Community Bank makes a $100,000 investment in a qualified affordable housing project in exchange for a 5% limited partnership interest.[8]

- Partnership finances the $4M project with 50% equity and 50% debt.
- Annual tax credit equal to 4% of the original cost of the property each year for 10 years (with a minimum investment commitment of 15 years).

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[6] FASB ASC paragraph 323-30-S99-1, available at www.fasb.org.

[7] FASB ASC Topic 740, Income Taxes, available at www.fasb.org.

[8] This example was obtained from FASB ASU 2014-01, available at www.fasb.org.

- Depreciation is determined using the straight-line method over 27.5 years.
- Deductions are limited to the initial investment of $100,000.
- Annual tax loss is equal to depreciation expense/deduction (project is otherwise break-even).
- SaveRite's tax rate is 40%.

	Net Investment	Amortization of Investment	Tax Credits	Net Losses/Tax Depreciation	Benefits from Tax Depreciation	Tax Credits & Other Tax Benefits	Net Tax Benefit
	(A)	(B)	(C)	(D)	(E)	(F)	(G)
1	90,909	9,091	8,000	7,273	2,909	10,909	1,818
2	81,818	9,091	8,000	7,273	2,909	10,909	1,818
3	72,727	9,091	8,000	7,273	2,909	10,909	1,818
4	63,636	9,091	8,000	7,273	2,909	10,909	1,818
5	54,545	9,091	8,000	7,273	2,909	10,909	1,818
6	45,454	9,091	8,000	7,273	2,909	10,909	1,818
7	36,363	9,091	8,000	7,273	2,909	10,909	1,818
8	27,272	9,091	8,000	7,273	2,909	10,909	1,818
9	18,181	9,091	8,000	7,273	2,909	10,909	1,818
10	9,090	9,091	8,000	7,273	2,909	10,909	1,818
11	6,666	2,424		7,273	2,909	2,909	485
12	4,242	2,424		7,273	2,909	2,909	485
13	1,818	2,424		7,273	2,909	2,909	485
14	-	1,818		5,451	2,183	2,183	365
15	-	-		-	-	-	-
		100,000	**80,000**	**100,000**	**40,000**	**120,000**	**20,000**

(A) Reflects the end of year investment for a 5% limited liability interest in the project, net of the periodic amortization in column (B).

(B) Computed as the initial investment of $100,000 × (total tax benefits received during the year in column (F) ÷ total anticipated tax benefits over the life of the investment of $120,000 shown as the total of column (F)).

(C) 4% annual tax credit on SaveRite's 5% share of the $4M project.

(D) Straight-line depreciation occurs over 27.5 years ($4M × 5% = underlying assets of $200K ÷ 27.5 years), limited to the amount of the initial $100,000 investment.

(E) Calculated as the net losses/tax depreciation × 40% tax rate.

(F) Column (C) + Column (E).

(G) Computed as the tax credits and other benefits in column (F), net of the investment amortization in column (B).

KPMG Observations

- In this example, SaveRite paid $100,000 for $120,000 of total tax benefits. Under the proportional amortization method, because the investment is amortized in proportion to the total of the tax credits and other tax benefits, approximately $0.83 ($100,000 ÷ $120,000) of investment amortization is recognized for every $1 of current tax benefit.
- All of the tax benefits are recognized in current tax expense as they are reflected on the tax return for the period. No deferred taxes are provided on the basis difference of the investment. This is similar to the accounting for the purchase of tax benefits addressed in ASC paragraphs 740-10-55-199 through 55-201.

Companies may also elect to apply a practical expedient (as opposed to the proportional amortization method) and amortize the initial cost of the investment in proportion to only the tax credits as long as the result is substantially similar to applying the proportional amortization method. Although the ASU does not illustrate the practical expedient and does not specifically address the recognition of deferred taxes, if the practical expedient is applied, we believe that investors would need to record deferred taxes on the basis difference of the investment because the book investment amortization and the tax return benefits are being recognized in different periods. Example 2 on the following page illustrates how we believe the practical expedient could be applied.

Example 2 – Applying the Practical Expedient

Assume the same facts as in Example 1, except that SaveRite Community Bank chooses to amortize its investment in proportion to only the tax credits. An illustration of the investment amortization is given below.

(A) Reflects the end of year investment for a 5% limited liability interest in the project, net of the periodic amortization in column (B).
(B) Computed as the initial investment of $100,000 × (total tax credits received during the year in column (C) ÷ total anticipated tax credits over the life of the investment of $80,000 shown as the total of column (C)).
(C) 4% annual tax credit on SaveRite's 5% share of the $4M project.
(D) Straight-line depreciation occurs over 27.5 years ($4M × 5% = underlying assets of $200K ÷ 27.5 years), limited to the amount of the initial $100,000 investment.
(E) Calculated as the net losses/tax depreciation × 40% tax rate.
(F) Column (C) + Column (E).
(G) Computed as the tax credits and other benefits in column (F), net of the investment amortization in column (B).
(H) The tax basis is computed as the initial tax basis of $100,000, less the tax depreciation of $7,273 computed in (D).
(I) The deductible temporary difference is the difference between the tax basis (Column (H)) and the book basis of the investment (Column (A)).
(J) Column (I) × 40%.
(K) The periodic change in the deferred tax asset in Column (J).
(L) Column (G) + Column (K).

	Net Investment	Amortization of Investment	Tax Credits	Net Losses/Tax Depreciation	Benefits from Tax Depreciation	Tax Credits & Other Tax Benefits	**Total Current Tax Benefit**	Tax Basis	Deductible Temporary Diff	Deferred Tax Asset	**Deferred Tax Benefit (Expense)**	**Net Tax Benefit**
	(A)	(B)	(C)	(D)	(E)	(F)	**(G)**	(H)	(I)	(J)	**(K)**	**(L)**
1	90,000	10,000	8,000	7,273	2,909	10,909	**909**	92,727	2,727	1,091	**1,091**	**2,000**
2	80,000	10,000	8,000	7,273	2,909	10,909	**909**	85,454	5,454	2,182	**1,091**	**2,000**
3	70,000	10,000	8,000	7,273	2,909	10,909	**909**	78,181	8,181	3,273	**1,091**	**2,000**
4	60,000	10,000	8,000	7,273	2,909	10,909	**909**	70,908	10,908	4,363	**1,091**	**2,000**
5	50,000	10,000	8,000	7,273	2,909	10,909	**909**	63,635	13,635	5,454	**1,091**	**2,000**
6	40,000	10,000	8,000	7,273	2,909	10,909	**909**	56,362	16,362	6,545	**1,091**	**2,000**
7	30,000	10,000	8,000	7,273	2,909	10,909	**909**	49,089	19,089	7,636	**1,091**	**2,000**
8	20,000	10,000	8,000	7,273	2,909	10,909	**909**	41,816	21,816	8,727	**1,091**	**2,000**
9	10,000	10,000	8,000	7,273	2,909	10,909	**909**	34,543	24,543	9,817	**1,091**	**2,000**
10	-	10,000	8,000	7,273	2,909	10,909	**909**	27,270	27,270	10,908	**1,091**	**2,000**
11	-	-	-	7,273	2,909	2,909	**2,909**	19,997	19,997	7,999	**(2,909)**	-
12	-	-	-	7,273	2,909	2,909	**2,909**	12,724	12,724	5,090	**(2,909)**	-
13	-	-	-	7,273	2,909	2,909	**2,909**	5,451	5,451	2,181	**(2,909)**	-
14	-	-	-	5,451	2,183	2,183	**2,183**	-	-	-	**(2,183)**	-
15	-	-	-	-	-	-	-	-	-	-	-	-
		100,000	**80,000**	**100,000**	**40,000**	**120,000**	**20,000**					**20,000**

KPMG Observations

The practical expedient accelerates the benefit recognition of the tax deductions into the credit period (before they are reflected on the tax return). This method may only be applied if the result is substantially similar to applying the proportional amortization method. This determination will require judgment and will depend on the individual facts and circumstances.

What Else Should I Be Thinking About?

Ongoing Qualification. Investors applying the proportional amortization method need to reevaluate the conditions if there is a change in the investment or if there is a change in the relationship that could result in the investment no longer meeting the conditions.

Impairment**.** LIHTC investments are impaired when it is more likely than not that the carrying amount of the investment will not be realized. We believe realization may be supported through the expected receipt of tax credits, other tax benefits, or through the sale of the investment. Impairment losses equal the difference between the fair value and the carrying amount of the investment and cannot be reversed. We expect that indicators of an impairment also would likely result in investors failing to meet the conditions to apply the proportional amortization method because the projected yield based on the tax credits and other tax benefits would no longer be positive.

Effective Tax Rate and Interim Periods. Because no deferred taxes are recognized under the proportional amortization method, all three components of income tax expense (investment amortization, tax credits, and other tax benefits) will be permanent items in the investor's effective tax rate reconciliation. The net impact of the LIHTC investment on income tax expense should be included in the investor's estimated annual effective tax rate used for interim reporting.

Disclosures. The guidance requires *all* LIHTC investors to disclose information that will enable financial statement users to understand the nature of their investments and the effect of those investments on their financial position and results of operations. To meet those disclosure objectives, the new guidance provides several disclosure suggestions that apply to all LIHTC investors, regardless of what accounting method is being applied.

Transition and Effective Date. The guidance must be applied retrospectively for annual periods, and interim periods within those annual periods, beginning after December 15, 2014, for public business entities. For all other entities, the guidance is effective for annual periods beginning after December 15, 2014, and interim periods thereafter. Early adoption is permitted and can be applied retrospectively in reporting periods for which financial statements have not yet been issued.

When applying the guidance retrospectively, companies should use the estimates and other information that was available when originally preparing the financial statements for those prior periods.[9]

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[9] FASB ASC paragraph 250-10-45-9, available at www.fasb.org.

Companies that are applying the effective yield method for qualifying LIHTC investments as of the date of adoption are permitted to continue using it for those pre-existing investments.

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