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Q&A

GAAP for Master Tenant Structures

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Question: How would a historic tax credit (HTC) investor in a master tenant structure account for its investment in accordance with Generally Accepted Accounting Principles (GAAP)?

Answer: This is a frequent question among HTC investors and syndicators breaking into the HTC market. For the answer we need to review our relevant GAAP literature regarding investments and look at several options. Questions need to be asked. Does the investment meet the standards to be accounted for on the cost method of accounting? Does the investment need to be accounted for on the equity method of accounting? Or is the investment a variable interest entity (VIE) that should be accounted for as a consolidation?

While a VIE analysis is outside the scope of this Q&A, generally, one would conclude under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 810-10 that the investment is a VIE, but that the investor is not the primary beneficiary and thus does not consolidate its investment. Therefore, we next look to Accounting Principles Board (APB) 18 for guidance. Under APB 18, or FASB ASC 323-10-15, an investor generally records an investment under the cost method when the investment is less than 20 percent of the voting stock of an investee and the investor does not have the ability to exercise a significant influence over the investee. If, however, the investor owns more than 20 percent of the voting stock of the investee and has the ability to exercise significant influence over the operating and financial policies of the investee, the investment should be accounted for using the equity method of accounting. Based on this guidance, it would seem appropriate that most HTC investments would fall into the equity method of accounting for GAAP purposes.

Under the equity method of accounting, the investor initially records the investment at cost and adjusts the investment balance for income or loss it is allocated and cash contributions made and distributions received. Additionally, the investment balance should be adjusted for any impairment in value that may exist. That brings up another common question, "How would an impairment charge on the HTC investment be determined and when should it be recorded?" With an HTC investment, substantially all of the benefits are received by the investor at the time the underlying project is placed in service. Although there is a five-year holding period for compliance purposes, the HTC benefit occurs in year one, with additional annual priority cash returns of approximately 2 to 4 percent received throughout the life of the investment. As a result, a large impairment charge of the HTC investment in the year that the underlying property is placed in service would be common. Generally, the investment value remaining after the placed-in-service date would be the investor's expected cash flows, any remaining tax benefits and the investment's residual value.

Even though the investment is ordinarily written off in year one due to the impairment calculation, there is a deferred tax component that needs to be considered for GAAP purposes. This is due to the basis of the investment being significantly different for GAAP as compared to the income tax basis. The investment basis for tax purposes is affected only by the pass through income or loss from the investee tax returns and contributions and distributions, but not impairment. This tax accounting is different for an investment in a master tenant structure than in a direct investment in an HTC project. A direct investment would require a reduction in the tax basis of the investment in the amount of the historic credit claimed. For the master tenant structure, this

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reduction does not occur; conversely the master tenant realizes income based on the credit claimed over the life of the underlying asset. For the master tenant structure the difference between the GAAP and tax accounting gives rise to a basis difference that results in a deferred tax asset (DTA). The DTA is a future tax benefit expected to be realized at the time of the disposition of the investment (generally after the HTC compliance period) due to the investment having a higher basis for tax purposes than for GAAP purposes.

Another consideration for accounting for an investor's HTC investment may be to use the fair market value approach. FASB 159, The Fair Value Option for Financial Assets and Financial Liabilities, specifies how an investor is able to elect the fair value option for financial assets or financial liabilities. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction and is based on either observable inputs, such as quoted prices, or unobservable inputs that may reflect an entity's own assumptions.

While the fair value approach is a viable option for recording the value of an HTC investment, the result would likely be the same as with the equity method of accounting taking into account the effect of impairment charges. This occurs since the fair value of the HTC investment is almost entirely based on the HTC itself, which would be realized in year one of the investment. The remaining fair value would then be based on the future cash flow stream, the same as with the equity method of accounting.

It is worth noting that there are many ways that investors may currently be accounting for their HTC investments, although it seems the most widely used choice would be the equity method of accounting along with an annual review for impairment. To summarize, any impairment loss reduces the investment balance and flows through the statement of operations as a charge against current GAAP earnings. Additionally, accounting for the GAAP/tax difference of the carrying value of the HTC investment will also flow through as a current credit to GAAP earnings. Investors should keep in mind that any HTC not used is recorded as a deferred tax asset on their balance sheets until utilized.

As one can see, the equity method of accounting is relatively simple to implement; however, there are a host of other GAAP considerations that investors must keep in mind while recording their investments in HTC projects.

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