

More Investors Consider Using the Effective Yield Method, Definition of Creditworthy Comes into Question

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Recent events in the U.S. financial markets have had many effects, including a decline in the prices being paid for low-income housing tax credits (LIHTCs), bringing prices to less than \$1 in most cases. This adjustment in equity prices means that an alternative to the equity method of accounting for LIHTC investments may be an option for more investors.

Generally, the equity method of accounting is required in accounting for limited partnership investments. However, limited partners that meet three criteria may elect to use a special method, known as the effective yield method, in recording their investment in a qualified affordable housing project through a limited partnership investment. One of the criteria for using the effective yield method is that there is a positive rate of return from the tax credits, and now that tax credit prices have dropped to less than \$1, more investors may consider using this alternative to the equity method.

The key benefit to using the effective yield method is that the tax credits generated are reported net of the investment amortization in as a component of income taxes, whereas, the equity method is reflected as an increase in operating expenses or decrease in income before taxes, with a corresponding decrease in income tax expense. Under the effective yield method, the risk of distorting operating performance metrics (such as "earnings before interest, taxes, depreciation and amortization," or EBITDA) and the financial statement presentation is reduced.

About the Effective Yield Method

Guidance about the effective yield method was provided in a report by the Financial Accounting Standards Board (FASB) in 1994. It discussed how an entity that invests in a qualified affordable housing project through a limited partnership should account for its investment. In Emerging Issues Task Force (EITF) issue No. 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects," three conditions are set forth that an investor must meet to use the effective yield method:

The availability (but not necessarily the realization) of the tax credits allocable to the investor is guaranteed by a creditworthy entity through a letter of credit, a tax indemnity agreement, or another similar arrangement.

The investor's projected yield based solely on the cash flows from the guaranteed tax credits is positive.

The investor is a limited partner in the affordable housing project for both legal and tax purposes, and the investor's liability is limited to its capital investment.

Under the effective yield method, the investor recognizes tax credits as they are allocated and amortizes the initial cost of the investment to provide a constant effective yield over the period that tax credits are allocated to the investor. The effective yield is the internal rate of return on the investment, based on the cost of the investment and the guaranteed tax credits allocated to the investor. Any expected residual value of the investment should be excluded from the effective yield calculation. Cash received from operations of the limited partnership or sale of the property, if any, should be included in earnings when realized or realizable.

Of the three criteria that must be met for using the effective yield method of accounting, one requirement in particular has been a subject of recent discussion. Specifically, many in the LIHTC community are wondering, what satisfies the criterion of a "creditworthy entity?"

What is Creditworthy?

EITF 94-1 does not define creditworthy. In other FASB accounting literature, there are fewer than a dozen references to the term creditworthy and nearly half of those references are as passing mentions in footnotes. There are two exceptions where the term is used in context, shedding at least a little light on the subject.

In EITF 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," FASB describes securitized financial assets of high credit quality as those that, for example, are "guaranteed by the U.S. government, its agencies, or other creditworthy guarantors..." indicating at least one benchmark for judging creditworthiness.

Alternatively, in FAS 143, "Accounting for Asset Retirement Obligations," FASB uses the term creditworthy in relation to an entity's relative credit standing. Various passages in FAS 143 suggest that an entity's credit standing or credit rating may be used as a factor in determining creditworthiness. However, nowhere in any accounting guidance are specifics mentioned regarding what constitutes a positive or adequate rating.

In the absence of a definitive standard, industry professionals may look to other sources in search of guidance. A cursory web search reveals definitions of "creditworthy" that include:

- Eligible to borrow money
- Financially sound enough to justify the extension of credit
- Deemed likely to repay debts
- Having an acceptable credit rating

According to definitions.uslegal.com, an online legal dictionary, "Creditworthy generally means characterized having an acceptable credit rating. The particular rating required to be considered creditworthy will vary by entity. Being creditworthy is indicative of being a responsible borrower, so that the likelihood of having a loan application accepted is increased." This reference also ties

creditworthiness to credit ratings. Furthermore, it notes that these ratings will vary by entity.

The Federal Reserve Bank of San Francisco's online glossary of economic terms defines creditworthiness as a creditor's measure of a consumer's past and future ability and willingness to repay debt. In banking circles, an entity is generally considered creditworthy if there is a less than remote probability that it would not be able to honor the obligation in question. "Less than remote" is often considered to mean a less than 5 percent chance.

Black's Law Dictionary defines a creditworthy borrower as "financially sound enough that a lender will extend credit in the belief that the chances of default are slight; fiscally healthy." As with the previous example, this definition refers to the chances of default—in this case using the word slight, rather than "less than remote." However neither "less than remote" nor "slight" are specific enough to provide a clear answer.

Conclusion

Despite the existence of these general descriptions, there currently appears to be no clear definition that LIHTC investors can use regarding what constitutes a "creditworthy entity" for the purposes of using the effective yield method of accounting for an LIHTC investment. What's more, as stated above, the definition of what may be considered creditworthy will also differ or vary by entity. Therefore, the threshold for acceptance of a guarantee from a creditworthy entity will be subject

to the investor's approval of the underlying pledge, security or other agreement regarding the availability of tax credits.

Clearly, this guarantee can be provided by the syndicator or a third party if acceptable to the investor. Without a reliable standard for creditworthiness, perhaps the more suitable question that syndicators should ask the investor in this scenario would be, "What assurances and criteria do you require when extending credit in a comparably priced transaction?"

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