Significant Changes Needed in Accounting for Affordable Housing and Other Tax Credit Investments

By Michael Beck and Bentley Stanton

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Executive Summary

Investments in low-income housing tax credits (LIHTC), known as affordable housing tax credit investments, are currently accounted for using one of several methods, the most predominant of which is the equity method. Other methods are also available and include the effective yield method (for investments that meet certain criteria), the cost method (when significant influence is not present), and the fair value method (in situations where the fair value option has been elected). Other than the effective yield method, current methods of accounting for tax credit investments require them to be presented as equity investments and not as purchases of tax benefits, separating the tax benefits of such investments from the cost of those benefits and presenting them in different locations on the income statement. The result is that they are reported in a manner that makes it difficult for investors to understand the true nature of the benefits purchased. The one option that does reflect their performance as purchases of tax credits, the effective yield method, is too restrictive and rules-based to be considered a readily available alternative for most tax credit investments. The success and growth of the LIHTC program along with an increase in other tax credit programs, such as the new markets, historic and renewable energy tax credit programs, has increased the focus on perceived issues with current accounting methods.

Since the Emerging Issues Task Force (Task Force) addressed the accounting for affordable housing tax credit investments under EITF 94-1, *Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects* (EITF 94-1), investment structures have evolved and most current investments do not provide the tax credit investor with any significant participation in the operations, cash flows, or residual values of the underlying real estate. Yet, only the effective yield method allows investors to account for these investments as a net purchase of tax credits. The other methods require the investment to be accounted for as an equity investment in a real estate entity. Other types of tax credit investments have also been developed that have similar characteristics but are not specifically addressed under EITF 94-1.

When the Task Force considered the issues under EITF 94-1 it focused on the risks related to the underlying real estate as a basis for its conclusions. However, affordable housing tax credit investments are significantly different than typical real estate investments. Performance in an affordable housing tax credit investment is based on receipt of the tax credits and other tax benefits. That performance is not impacted positively or negatively by the profitability of the related real estate, except in rare situations involving property entity failure. The cash flows of the underlying real estate entity and the real estate risks are retained by the general partner.

The Task Force concluded that affordable housing tax credit investments that do not qualify for the effective yield method should be accounted for in accordance with AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures* (SOP 78-9). Under SOP 78-9, the equity method of accounting is required. The problem with the equity method of accounting for affordable housing tax credit investments is that it distorts investment performance. This occurs because the equity method results in pre-tax losses being reported when the investment is performing as intended and yielding an after-tax net benefit to the investor. In addition, the tax credits, which are the primary benefit of the investment, are not reflected as a component of investment performance. Instead, they are reported as a component of income tax expense.

None of the currently available methods of accounting other than the effective yield method, which is only narrowly available, report net investment performance as a single, understandable amount. As a result, many investors limit or altogether avoid tax credit investments in order to avoid what is perceived to be adverse pre-tax accounting impacts from a net accretive investment.

The FASB's current project on accounting for financial instruments provides the Board with an opportunity to address the accounting for all types of tax credit investments that share similar characteristics. Since many tax credit investments are structured as equity investments, the current scope of the project on accounting for financial instruments would include most of the tax credit investments described in this paper. Further, as a result of the project on accounting for financial instruments, the use of the effective yield method likely will come under reconsideration. The increased number of tax credit programs and the use of equity investment structures to facilitate investor purchases of those tax credits make the need for a comprehensive solution more important than ever.

As part of its project on accounting for financial instruments, we urge the FASB to develop a principles-based accounting method that could be applied to all types of tax credit investments that share similar characteristics, rather than a rules-based method for a single specific investment structure. Such investments typically are designed in a manner where the investment is primarily a purchase of tax benefits and the investor does not participate in any significant manner in the economic success or failure of the investee's underlying operations. Qualifying investments should be accounted for as purchases of tax benefits or the tax benefits should be treated as a tax-exempt component of pre-tax earnings. An important objective of the accounting method would be to report the impact of investment benefits together with the impact of the cost of the investment within one financial line item in a meaningful and understandable manner. Additionally, financial presentation in such a manner would promote transparency and usefulness of the costs and benefits of these investments to both investors and other users.

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Overview and scope

1. Affordable housing tax credits, more commonly known as low-income housing tax credits (LIHTC), were enacted under Section 42 of the Internal Revenue Code (IRC) as part of the Tax Reform Act of 1986, and were made a permanent part of the IRC by the Revenue Reconciliation Act of 1993. The LIHTC program is designed to encourage investment of private capital for use in the construction of affordable housing and to allow third-party investors to receive the benefits of the tax credits allocated to an affordable housing tax credit property entity. An investor generally receives the benefits of the tax credits by making an equity investment in the entity that owns the affordable housing tax credit property. For federal income tax purposes, the general requirement for a profit motive under Section 183 does not apply to LIHTC investments.

2. Since its inception, the LIHTC program has grown to become one of the most successful government-sponsored housing programs in history and has grown to over $8 Billion in annual budget authority[1] (*see* **Appendix A, *LIHTC Overview***, *for a detailed description of the LIHTC program and typical investment structures*). Other tax credit programs, such as the New Market Tax Credit (NMTC) program(*see* **Appendix B, *NMTC Overview***, *for a detailed description of the NMTC program and typical investment structures*), historic tax credits (HTC) (*see* **Appendix C, *Historic Tax Credit Overview***, *for a detailed description of the HTC program and typical investment structures*) and renewable energy investment tax credits (REITC) (*see* **Appendix D, *Renewable Energy Investment Tax Credit Overview***, *for a detailed description of the renewable energy investment tax credit program and typical investment structures*), have used similar models as a means of encouraging investment of private capital for strategic and economic development purposes. It is common for investors who wish to purchase tax credits to be required to structure their purchases as equity investments, which has resulted in a specific category of equity investment known as a "tax credit investment."[2]

3. Current accounting guidance, with one limited exception (the effective yield method), treats tax credit investments in the same manner as traditional equity investments (primarily because of their structure) and requires them to be either consolidated or accounted for using the equity method.[3] The equity method is not designed to account for tax benefits, which are the primary benefits of a tax credit

[1] HUD LIHTC Database located at the HUD.gov website.
[2] Although this paper is focused primarily on affordable housing tax credit investments, many of the concepts and the issues also apply to other types of tax credit investments.
[3] Other methods, such as the cost method and fair value, are also available. However, the method most commonly used is the equity method.

investment. It is designed to account for investments where the investor has significant influence over investee operations and is more of an operational measurement of investment performance.

4. Most affordable housing tax credit property entities are considered variable interest entities and the general partner (managing member in an LLC) of the entity is typically considered the primary beneficiary and, therefore, is required to consolidate the entity. This conclusion is based on the general partner's (managing member in an LLC) ability to direct the significant operating activities of the entity along with its obligation to absorb losses and its right to receive benefits related to the operation of the entity. In limited cases, a tax credit investor may develop an affordable housing property for its own benefit or a reconsideration event may occur which provides the investor with a controlling financial interest. This paper addresses the accounting for equity investments made by an investor for the primary purpose of obtaining tax credits.

5. Application of the equity method to a tax credit investment separates the primary benefits derived from the investment, the tax benefits, from the measurement of investment performance.[4] As a result, both the nature of the investment and investment performance are reported in a manner which often can be difficult to understand and may lead to inaccurate conclusions by financial statement users. The LIHTC program was in its initial years when the current accounting guidance was issued and other tax credit programs did not exist. Since that time, the LIHTC program has matured, HTC, NMTC, REITC programs have expanded the tax credit investment space, and tax credit investment terms have evolved to the point where investors now invest primarily in the tax credits and have no significant participation in the underlying real estate or operations of the other tax credit investment entities.

6. The purpose and scope of this paper is to address issues with accounting methods currently required to be applied to tax credit investments as well as potential issues with accounting being considered in connection with the FASB's current project on accounting for financial instruments and to address the need for a new, more principles-based approach to the accounting that reflects the unique nature of these types of investments. The current accounting methods create income statement geography or classification issues that distort the measurement of investment performance and the accounting has now become one of the most significant issues raised by investors considering affordable housing and other tax credit investments.

Previous Consideration of Accounting for Affordable Housing Tax Credit Investments

7. Accounting issues related to affordable housing tax credit investments and the effective yield method of accounting were addressed by the Emerging Issues Task Force (EITF or the Task Force) on two

[4] While the fair value option and the cost method utilize significantly different measurements of investment income or loss than that used under the equity method, they both separate the primary benefits derived from the investment from the measurement of investment performance.

separate occasions. The first time was when the Task Force issued EITF 94-1, *Accounting for Tax Benefits Resulting from Investments in Affordable* Housing *Projects* (EITF 94-1). The second time was when it issued EITF 98-11, *Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as a Business Combination* (EITF 98-11).

Previous EITF 94-1 Considerations

8. EITF 94-1 is the primary guidance related to accounting for affordable housing tax credit investments. During the development of EITF 94-1, the Task Force members discussed whether affordable housing tax credit investments were more akin to investments in real estate or receivables. The structure of these investments as equity investments led the Task Force working group to observe that they were "not aware of any transactions in which no risks and rewards of ownership are present."[5] Ultimately, the Task Force concluded that affordable housing tax credit investments were more like real estate and should be accounted for in accordance with AICPA Statement of Position 78-9, *Accounting for Investments in Real Estate Ventures* (SOP 78-9). Under SOP 78-9, use of the equity method of accounting is required unless the limited partnership interest is so minor as to have virtually no influence.[6] The only exceptions to application of the equity method under SOP 78-9 are the cost method, the fair value option and the effective yield method.

9. The Task Force considered affordable housing tax credit investments with third-party guaranties to be different and allowed such investments to be accounted for using an alternative method of accounting, the effective yield method (which is discussed in a subsequent section of this paper).

Previous EITF 98-11 Considerations

10. Application of the effective yield method was again discussed by the EITF in its deliberations related to issuance of EITF 98-11. Comment letters received in connection with EITF 98-11 requested the Task Force to consider broader application of the effective yield method and to allow other tax benefits associated with affordable housing tax credit investments to be incorporated into the determination of the yield.

11. During its deliberations the Task Force discussed differences between investments that represent purchases of tax benefits and those that represent acquisitions of assets with favorable tax attributes. They also discussed differences between tax-advantaged transactions entered into directly with government entities and those entered into with non-taxing entities.

[5] Minutes of the March 24, 1994 EITF Meeting
[6] Paragraph 8 of SOP 78-9

12. Ultimately the Task Force did not modify or expand application of the effective yield method beyond what was provided for in EITF 94-1. They did reaffirm their previous conclusion that purchases of future tax benefits should be accounted for as an investment using the effective yield method.[7]

13. One of the reasons given by the Task Force why other tax benefits (such as the tax benefits from deductions related to the investment) should not be incorporated into the effective yield method was their belief that if other deductions were allowed to be included in the determination of the yield, it would become difficult to differentiate between investments in limited partnerships that should be accounted for in accordance with SOP 78-9 (using the equity method) and those that should be accounted for using the effective yield method.[8]

Consideration of Current FASB Project on Financial Instruments

14. The FASB has a current project on "Accounting for Financial Instruments" which may result in a requirement that tax credit investments be measured at fair value. Tax credit investments generally are not made by investors for strategic operating purposes. In addition, many tax credit investments could be viewed as held-for-sale given the likelihood of disposition of the investment after the tax credits have been received. Such classification as held-for-sale would potentially result in a requirement to measure the investment at fair value with the changes in fair value being included in earnings.

15. The proposed recommendations that follow are not intended to conflict with this or other current projects at the FASB. However, we believe certain issues related to the classification and presentation of gains and losses which result from measuring tax credit investments at fair value need to be addressed as part of the project. In particular, we believe that the FASB needs to consider the unique nature of tax credit investments as part of the financial instruments project and address the accounting comprehensively with a new, more principles-based approach that could be applied to all types of tax credit investments and which would enhance the transparency and usefulness of the impacted financial statements for investors and other users. Tax credit investments are too significant and unique in nature not to be given separate consideration as a part of this project. These issues are discussed further in the following section under **Issues related to the fair value option**.

Issues with Current Accounting Methods

Issues related to relevance and reliability

16. Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (CON 5), views financial statements as a central feature of financial

[7] Minutes of September 23-24, 1998 EITF meeting
[8] Paragraph 15 of Issue Summary No. 1, Supplement No. 3 of EITF 98-11

reporting. Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises* (CON 1), states that the role of financial reporting is to provide information that is useful in making business and economic decisions.[9] The usefulness of financial reporting is impacted by its quality. Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (CON 2) addresses the issue of quality and indicates that the qualities that distinguish "better" (more useful) information from "inferior" (less useful) information are primarily the qualities of relevance and reliability.[10]

17. To be relevant, CON 5 indicates that the information must have the capacity to make a difference in user decisions. To be reliable, CON 5 indicates that the information should be representationally faithful, verifiable, and neutral. CON 1 specifically addresses enterprise performance and earnings and states that the primary focus of financial reporting is to provide information about an enterprise's performance provided by measures of earnings and its components.[11] In that regard, financial statements usually classify and aggregate items with essentially similar characteristics. Reported earnings measures the performance of the entity and provides information regarding what the entity has received or reasonably expects to receive in connection with the utilization of its resources.

18. Management, as stewards of entity resources, is expected to make a profit on its investments. When management uses entity resources to make affordable housing tax credit investments, the ultimate test of success (or failure) of the investment is the extent to which the investment returns more (or less) cash in the form of tax credits and other tax benefits than the entity invested. A successful investment implies not only a return of the original investment, but also a return on that investment commensurate with the risk involved.

19. When management makes an affordable housing tax credit investment, it does so with the expectation that it will receive a profit on the investment consisting of tax credits and other tax benefits. However, as described in the sections below, even though the investment is performing as expected and generating an after-tax profit, the equity method of accounting for affordable housing tax credit investments requires the tax credit investor to report pre-tax losses on the investment. Here, the current accounting for affordable housing tax credit investments has not met the financial reporting objectives of relevancy and reliability.

20. Users of the financial statements often make investment decisions or recommendations based on the reported pre-tax financial performance of the tax credit investor. That performance is negatively impacted by the application of the equity method to affordable housing tax credit investments. The perception of negative performance portrayed by the accounting presentation has risen to the level many potential investors now shy away from these types of investments solely due to the anticipated

[9] Paragraph 33 of CON 1
[10] Paragraph 15 of CON 2
[11] Paragraph 43 of CON 1

negative accounting impact on their pre-tax earnings. This avoidance occurs despite the net positive impact these investments are known to have on the entity's overall financial performance.

Issues related to use of the equity method

21. SOP 78-9 was issued in 1978 by the Accounting Standards Division (Division) of the AICPA to address accounting for real estate ventures regardless of the form of the investment. The equity method of accounting was recommended by the Division as the preferred method of accounting for noncontrolling ownership interests in limited partnership investments in real estate. The Division based this conclusion on its belief that the equity method best reflected the underlying nature of the investment. We believe the equity method continues to be an appropriate method of accounting for investments in limited partnerships where the principal purpose of the investment is to invest in real estate.

22. Investors who make limited partnership investments in real estate (referred to herein as traditional real estate investments) do so primarily to earn a profit on their investment from the real estate. That profit is provided by the cash flows generated from property operations and from appreciation of the real estate, which is realized upon disposition of the investment.

23. Under the equity method the investor records its share of the investee's earnings. Guidance related to the equity method states that it is most appropriate as a method of accounting if an investment enables the investor to influence the operating or financial decisions of the investee.[12] Application of the equity method requires the investor to record in earnings its proportionate share of the earnings of the investee. It is the most accurate when investee operations reflects investment performance and when the investor has the ability to influence those operations.

24. Under the equity method, recognition of investee earnings implies an increase in the value of the investment and the expectation of future cash flows to be received either from distributions from the investee or from sale of the investment. Conversely, recognition of losses implies a decrease in the value of the investment and the expectation of diminished future cash flows from investee distributions or from sale of the investment.

25. By design, investors in affordable housing tax credit investments generally do not look to the cash flows of the underlying real estate or its eventual disposition for their investment yield. Rather, their yield is based primarily on the receipt of tax credits and other tax benefits resulting from their investment. The equity method does not accurately measure performance of this type of investment where investee operations have little impact on the investment.

[12] Paragraph 5 of ASC 323-10-5

26. Affordable housing tax credit property entities are designed to operate at or near breakeven from a cash flow perspective. Once non-cash depreciation charges are recognized, most affordable housing tax credit property entities report net losses in their financial statements.

27. Use of the equity method of accounting for affordable housing tax credit investments distorts investment performance and makes it appear that something is wrong with the investment when no problem exists. This occurs because the equity method results in pre-tax losses being reported when the investment is performing as intended and yielding an after-tax net benefit to the investor.

28. Additional losses on the investment in excess of those recorded under the equity method may be required to be recorded at the investor level whenever the carrying value of the investment exceeds the amount of the remaining tax benefits. This usually occurs in the later years of the investment when the remaining tax credits expire. Such impairment losses can occur regardless of the performance of the underlying real estate. Further, once impairment losses begin they usually continue on an annual basis due to the significance of the expiring tax credits in relation to the investor's share of investee earnings. Recording impairment losses on a recurring basis when there is no change in the underlying investment other than the scheduled and anticipated receipt of the purchased tax credits provides evidence that the equity method is ineffective as a method of measuring investment performance.

29. Another and perhaps the most significant issue users have with the equity method of accounting for affordable housing tax credit investments is that the tax credits and other tax benefits are required to be reported separately from investment earnings (losses) as a component of the investor's overall income tax provision. This separation of benefits from reported investment performance makes it difficult for users of financial statements to understand affordable housing tax credit investment performance. The end result is that the identifiable portion of investment performance is reported as a loss and that loss excludes substantially all of the benefits derived from the investment.

Issues related to the effective yield method

30. One exception to the requirement to use the equity method is the effective yield method. Under the effective yield method, qualifying LIHTC investments are allowed to be reported as a net purchase of tax credits. The net benefits are included as a component of the tax credit investor's tax provision. The amount of net benefits is recognized as a constant yield on the carrying value of the net investment as the tax credits are received. That is, in general, there are no pre-tax losses or earnings recognized in the financial statements for investments that qualify for the effective yield method of accounting.

31. The issue with the effective yield method is the significant restrictions which must be met in order for an investment to qualify.[13] One of the more significant hurdles that must be met in order to qualify for the effective yield method is that the amount of the tax credits must be guaranteed by a creditworthy guarantor. While no specific guidance is provided (in ASC 323-740) regarding what types of entities would be considered creditworthy guarantors, the guidance makes reference to such guaranties being similar to a letter of credit or tax indemnity agreement, which has been interpreted as a high threshold of creditworthiness.

32. The rationale regarding the need for a creditworthy guarantor is based on the uncertainty related to the availability of the tax credits. The guarantee protects the tax credit investor against the economic loss that it would incur from the loss or recapture of the tax credits. The risk that the tax credits will be made available (or not made available) to the investor is not changed by the existence of a third party guaranty. Any payments the tax credit investor might receive under such a guarantee would be in lieu of receipt of the tax credits.

33. Limiting the application of the effective yield to credit enhanced investments has limited the use of this method of accounting to only a small portion (less than 5%[14]) of affordable housing tax credit investments. As a result, the effective yield method, while appropriate, is too restrictive and rules-based in its application to provide any meaningful and realistically available alternative to the equity method.

Issues related to the fair value option

34. Under the fair value option, investors would measure investment performance based on the change in fair value of the investment at each reporting period. The primary components of fair value in an affordable housing tax credit investment are the amount of remaining tax credits and the market price of tax credits on the measurement date.[15] Over the term of the investment, and assuming no changes in the market price, the fair value of the investment would decrease as the tax credits were used and the remaining amount of available tax credits declined.

35. While use of the fair value option would accurately measure the change in fair value of the investment, the decline in the remaining tax benefits would result in losses being reported on the investment even though it is performing as intended and yielding a net benefit after taxes.

[13] In order to qualify for the effective yield method of accounting investments must meet all of three criteria: a) availability of the tax credits must be guaranteed by a credit worthy entity; b) the investor's projected yield based solely on the cash flows from the guaranteed tax credits is positive; and c) 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 [ASC 323-740-25-1].
[14] Guaranteed investments are estimated to be less than 5% of all affordable housing tax credit investments based on surveys of active syndicators and investors.
[15] Additional inputs and assumptions, such as discount rates, could also be incorporated into the measurement of fair value. However, such adjustments are generally reflected in the market price of the tax credits.

36. Any measurement that fails to match the change in the fair value of the investment attributable to the use of the tax credits with the related recognition of the tax benefits will result in the same distortion of investment performance that exists under the equity method. The changes in fair value of a tax credit investment that result from receipt of the tax credits should be classified together with the tax credits as a component of income taxes and not as a component of pre-tax earnings. Otherwise, if the decline in fair value is reported separately as a component of earnings before taxes, the performance of the investment will be reported as a loss while the tax benefits continue to be reported separately within the tax provision.

37. We are concerned that current accounting under the fair value option as well as proposed guidance under the FASB's current project on "Accounting for Financial Instruments" does not provide for or allow any segmentation of the changes in fair value attributable to the use of tax credits. Such a result would simply change the method of measurement of the investment without addressing the issue of classification and reporting for tax credit investments in a clear and understandable manner. If the Board decides to require these types of investments to be measured at fair value, it is imperative that the Board address the classification of the changes in fair value to better match the costs and benefits of tax credit investments within the financial statements.

38. Tax credit investments structured as equity investments and made for the purpose of purchasing tax credits have different characteristics than other types of equity investments. Accordingly, they should not be accounted for in the same manner as other equity investments. Application of fair value measurements in accounting for tax credit investments only addresses the measurement issue. The FASB needs to give consideration to development of a new, principles-based method of accounting that addresses the unique nature of these investments in a manner that incorporates the combination of pre-tax investment dollars and tax benefits as a single, understandable amount, regardless of how the carrying value of the investment is measured.

Issues related to improved disclosure solutions

39. Some suggest that the reporting issues can be adequately addressed by improving the disclosures related to tax credit investments. Those offering this solution suggest that better disclosures would eliminate the confusion and provide a viable remedy to the reporting problems without changing the underlying accounting.

40. A disclosure solution would involve extracting selected portions of investment performance information together with extracting selected portions of income tax provision information in order to present the economic effect of the tax credit investment. The inability to associate the information in the disclosure with the information reported in the financial statements would detract from its usefulness. Unless the users of the financial statements were aware that investment performance included losses from tax credit investments, they might have no reason to question the investment

performance reported in the income statement. While improved disclosure might help users of financial statements better understand tax credit investments, it would not adequately address the classification and presentation issues for these investments.

Consequences of Current Accounting Method Issues and the Need for Change

41. The separate reporting of costs and tax benefits resulting from application of the equity method of accounting for affordable housing tax credit investments can make it more difficult for investors to explain the underlying, beneficial economic performance of these investments to analysts and other users of their financial statements.

42. Many tax credit investors believe the accounting for affordable housing and other tax credit investments causes their operating performance to be negatively perceived by users of the financial statements. This occurs because investors are required to report pre-tax losses (which generally are evaluated more harshly than the offsetting tax credits since they are considered an indicator of long-term performance) and investors are required to report the offsetting tax credits in their income tax provision (which generally are evaluated less favorably than the pre-tax losses since tax benefits are considered to be more year-to-year and less of an indicator of long-term performance). Compounding this issue is the difficulty of identifying the tax benefits of these investments within the details of an entity's tax provision. Even if the tax benefits of the investment are disclosed, most analysts do not (nor should they be expected to) convert the separately reported amounts into an integrated presentation.

43. In response, some investors will attempt to explain the accounting by providing non-GAAP disclosures outside of the basic financial statements. Other investors will only invest in affordable housing tax credit investments that qualify for the effective yield method, electing to pay a premium (usually significant) for a guarantee that will provide them with the preferred accounting results. [16]

44. Analysts likely do not understand the accounting for affordable housing and other tax credit investments and interpret investment performance through the filter of the accounting method used by the tax credit investor. They assume the method of accounting and presentation within the financial statements are appropriate and, therefore, accept the reporting of investment performance at face value. Since investment performance is usually accounted for under the equity method, many analysts and other users of financial statements view the performance of affordable housing tax credit investments the same way they would view the performance of traditional real estate investments. Accordingly, as losses are reflected in operations and the related benefits are reflected as a component

[16] In an article by Leslie A. Robinson Dartmouth College, *Do Firms Incur Costs to Avoid Reducing Pre-Tax Earnings? Evidence from the Accounting for Low-Income Housing Tax Credits*, he found that investors pay, on average, 15.8% of their total investments for the guarantee.

of income taxes, the users of investor financial statements often misinterpret affordable housing and other tax credit investments to be unfavorable to the investor's financial performance.

Equity Investment Structure: Substance versus Form

45. Most affordable housing tax credit investments provide the investor with protective rights related to their investment and generally do not provide the investor with significant participating rights related to the operations of the property. As previously noted, substantially all of the benefits received under these investments consist of tax credits and their substance is principally one of a purchase of tax benefits. The form of these investments is one of an equity investment, which is prescribed under the Internal Revenue Code in order for the investor to receive the tax credits.

46. In almost all situations involving substance versus form considerations, the accounting guidance requires the application of judgment in order to determine the appropriate accounting treatment. As such, we would expect considerable judgment to be required in order to determine whether a specific investment is a tax credit investment or an operating investment.

47. In other words, investments in affordable housing tax credit property entities that are structured in a manner where the investor retains significant operational influence and has significant rights to receive benefits other than the tax credits are indicative of an investment which in substance is more one of a real estate investment and less one of a tax credit investment.

48. Conversely, investments in affordable housing tax credit property entities that are structured in a manner where the investor has primarily protective rights and has only insignificant rights to receive benefits other than the tax credits are indicative of an investment which in substance is more one of a tax credit investment and less one of a real estate investment.

Indirect investments using Tax Credit Funds

49. Affordable housing tax credit investments can be made either as direct investments (where the investment ownership is made directly in the affordable housing property entity) or as indirect investments (where the investment ownership is made indirectly in the affordable housing property entity using intermediary investment entities (Tax Credit Funds)).

50. Investors in Tax Credit Funds are one step further removed from the underlying real estate and its operations. Investors in indirect investment entities generally receive only the tax credits allocated to the Tax Credit Funds by the affordable housing property entity. Use of indirect investment structures can often make it even clearer that the substance of the investment is primarily one of a purchase of tax credits.

51. Investments in Tax Credit Funds raise consolidation issues which are different from those related to direct investments in affordable housing tax credit property entities. Tax Credit Funds are usually sponsored by syndicators and may provide investors with varying degrees of participation and control over investment activities. Many of the issues related to consolidation which exist in connection with investment companies also exist in connection with Tax Credit Funds. However, Tax Credit Funds usually do not qualify as investment companies.

52. We believe that Tax Credit Funds should be considered in a manner similar to investment companies with regard to consolidation. Investors should not be required to consolidate Tax Credit Funds which are used solely to make tax credit investments. Since Tax Credit Funds generally do not consolidate their investments in affordable housing tax credit property entities, consolidation of a Tax Credit Fund by an investor accomplishes little. The result is that the investor ends up reporting the individual, unconsolidated affordable housing tax credit investments of the Tax Credit Fund on its balance sheet instead of its investment in the Tax Credit Fund.

53. Regardless of whether the tax credit investment is made in an affordable housing tax credit property entity or in a Tax Credit Fund, we believe the central issues related to the accounting are the nature of the investment and the need to combine investment costs with the related tax benefits when reporting investment performance.

Attributes of Affordable Housing Tax Credit Investments as Tax Credit Investments versus Real Estate Investments

54. Traditional real estate investments have well-known investment attributes. They provide investors with a return of their investment and a return on their investment. That return is provided by a combination of cash flows generated from property operations and from appreciation of the real estate. Large ownership interests in traditional real estate entities usually provide the investor with significant influence over property operations. The rate of return investors require in connection with traditional real estate investments is significantly higher than that required in risk-free investments and reflects the additional risks associated with real estate.[17]

55. The risks and rewards to tax credit investors are considerably different. By design, tax credit investors generally do not look to the cash flows of the underlying rental property or its eventual disposition for their investment yield. Rather, their yield is based on the receipt of tax credits and the tax benefits resulting from their investment. Because the yield is not dependent upon property operations and instead comes from government-sponsored tax benefits, the rate of return a tax credit

[17] Additionally, the rate of return required by an investor in an undeveloped property would be substantially higher than the rate of return required for an operating property. The additional return would be required as compensation for the additional risks associated with development and rent-up of the undeveloped property.

investor requires from a tax credit investment is usually substantially less than the comparable rate of return required by an investor in traditional real estate investments.

56. The primary risks to investors in affordable housing tax credit investments consist of compliance risk and foreclosure risk. Realization of the tax credits is dependent upon the affordable housing tax credit property being placed in service and the rental units being leased to qualified low-income tenants at qualified rents. Generally, qualified rents are lower than market rents in the same locations.

57. The risks and rewards of the underlying real estate are usually retained by the general partner (or managing member in an LLC) of the affordable housing tax credit property entity. To the tax credit investor, the operations of the affordable housing tax credit property entity have limited significance. The tax credit investor continues to receive its tax credits as long as the property rents the low-income units to qualified tenants and charges them qualified rents. How much (or how little) cash flow or income the property generates does not affect the amount or timing of receipt of the tax credits the investor receives. Performance of the affordable housing tax credit investment is relatively unaffected by the affordable housing tax credit property's operating success or struggles. Many tax credit investors have little knowledge of or interest in the underlying real estate and do not participate in the operations of the property. They rely on the general partner (or managing member in an LLC) to operate the property. Their rights to participate in entity decisions are limited primarily to protective rights.

58. To encourage investments in affordable housing tax credit property entities, the U.S. Treasury waived its usual requirement that such investments have a profit motive under Section 183.[18] This is significant since equity investments are generally required to have a profit motive for tax purposes. By waiving the profit motive, the U.S. Treasury effectively condoned investments in affordable housing tax credit property entities being made for the purpose of obtaining tax benefits.

59. Waiver of the profit motive means that even though tax credit investors are required to acquire an ownership interest in the entity that owns the affordable housing property entity, the investment can be structured in a manner whereby the significant economic benefits the tax credit investor receives from the investment can be limited primarily to the tax benefits. In other words, the tax credit investor is not required to demonstrate at inception of its investment a reasonable expectation of recouping its investment and earning a profit based solely on cash flows from the investment. No return of capital and no substantial participation in property income or appreciation are required to be provided to the tax credit investor. As a result, tax credit investors in affordable housing tax credit entities have significantly different investment goals than property owners or investors in traditional real estate entities. This can be demonstrated by comparing the objectives of the two investments and the different types of benefits investors receive as shown in **Table 1** below.

[18] Internal Revenue Code regulations Section 1.42-4

Table 1: Comparison of Investments		
	Affordable Housing Tax Credit Investment	Traditional Real Estate Investment
Investment objectives	Tax benefits	Cash flows
Source of benefits	Government	Investee
Factors that affect price of investment	Amount and price of tax credits	Cash flows and cap rate
Right to participate significantly in cash flows from real estate operations	No	Yes
Right to participate significantly in residual value of real estate	No	Yes
Sale of real estate significant to exit strategy and to return on investment	No	Yes

60. To illustrate the significant differences in the sources of benefits between an affordable housing tax credit investment and a traditional real estate investment a brief example is provided in **Table 2**.

Table 2: Comparison of Source of Benefits Between Investments		
	Affordable Housing Tax Credit Investment	Traditional Real Estate Investment
Investment	$ (1,250,000)	$ (1,250,000)
Distributions from operating cash flows	-	1,000,000
Distributions from sale	-	1,250,000
Net cash flows from (to) property	(1,250,000)	1,000,000
Taxes		
LIHTC	1,470,588	-
Tax (expense) benefit	437,500	(350,000)
Total taxes received from (paid to) government	1,908,088	(350,000)
Net benefits received	$ 658,088	$ 650,000
Assumptions:		
Investment	1,250,000	1,250,000
LIHTC	1,470,588	N/A
Price per LIHTC	$ 0.85	N/A
Cap Rate	N/A	8.0%
Annual cash flow participation	None	100,000
Term	10 Years	10 Years
Residual value participation	None	1,250,000
Tax rate	35%	35%

61. The comparison of investment performance measurements is even more pronounced when the two investments are accounted for under the equity method, which is illustrated in **Table 3** below. Given the significant differences between traditional real estate investments and affordable housing tax credit investments, it is inconsistent for them to be accounted for using the same method of accounting.

Table 3: Accounting Comparison of Investments Using Equity Method		
	Affordable Housing Tax Credit Investment	Traditional Real Estate Investment
Investment earnings:		
Share of net income (loss) on investee operations	$ (1,250,000)	$ 545,000
Gain on sale	-	455,000
Net investment earnings	(1,250,000)	1,000,000
Taxes		
LIHTC	1,470,588	-
Tax (expense) benefit	437,500	(350,000)
Total taxes	1,908,088	(350,000)
Net income	$ 658,088	$ 650,000

Other Types of Tax Credit Investments

62. Other types of tax credit investments which have been mentioned in this paper include NMTC, HTC and renewable energy investments. While these are the most common and reflect the largest amount of investment activity, they are not the only types of other tax credit investments.

63. NMTC, HTC and renewable energy tax credit investments all share certain investment structure attributes with affordable housing tax credit investments (these structures are all described in detail in appendices B, C and D). Generally, they are structured as equity investments in entities that are formed specifically to qualify for tax credits under the respective Federal and state tax credit programs. The entities vary as to the types of business operations they conduct. However, the common feature is that the tax credit investment is structured in a manner where the controlling financial interest as well as the risks and rewards of those businesses are retained by the other owners and not by the tax credit investor. Where operational risks exist, the other owners typically provide guarantees to protect the tax credit investor from absorbing those losses. Likewise, the investments are structured where the tax credit investor does not have any significant rights to receive benefits resulting from operations or from residual values. Such benefits are also retained by the other owners.

64. Similar to affordable housing tax credit investments, the value of such investments consists principally of tax credits and declines as the related tax credits are received. The other owners of these entities look at the tax credit investor as a financing source which allows them to monetize the tax credits for which the entity qualifies. They do not offer tax credit investors more than insignificant participation in income or capital appreciation on the entity's assets or operations.

65. The NMTC program (see **Appendix B**) was created by the Treasury under section 45D of the Code to promote loans and certain other investments in qualifying active low-income community businesses, or QALICBs. Investors providing financial assistance under the NMTC program can qualify for a 39% tax credit on the amount of its qualified investment. The tax credit investor typically receives substantially all their return from the tax credits and is protected from risks resulting from the operations of the QALICBs.

66. HTCs (see **Appendix C**) are awarded by the Treasury under Section 47 of the Internal Revenue Code (Code) as an incentive to rehabilitate historic structures. The HTC is based on a percentage, usually 20%, of qualified rehabilitation expenditures made to preserve historic structures and is awarded to its owners. In exchange for the HTC benefit, the owner of the historic structure is required to reduce its depreciable basis by the amount of the HTC.

67. Property owners will often create ownership structures designed to allocate their HTCs to an independent investor whose capital can be used to partially fund rehabilitation costs. One structure that has found favor with owners and investors alike is the lease pass-through structure allowed under Section 50d of the Code. These structures are typically designed to segregate the tax credit investor from the risks and benefits of the related real estate. Similar to affordable housing tax credit investments, the HTC tax credit investor does not have any significant participation in the operations of the underlying real estate. The structure of the HTC investment is designed to protect the tax credit investor from losses that might result from the operations of the underlying real estate and usually include guarantees from the other owners. Such structures are also designed to prevent the tax credit investor from receiving any significant benefits resulting from the operations of the real estate and its residual value.

68. Renewable energy credits (see **Appendix D**) are available under Section 48 of the Code and take the form of investment tax credits (ITCs). Energy credits are designed to encourage investments in renewable energy equipment. The ownership structures for tax credit investors are often similar to those used in connection with HTC investments.

69. Investment structures used in connection with other types of tax credits, such as HTCs and REITCs are increasingly structured as equity investments in order to attract investors solely interested in obtaining the tax credits. In many cases the investor uses an indirect investment vehicle (Tax Credit Fund) to make the investment.

70. Federal low-income housing tax credits allocated to qualified properties total approximately $8 billion annually. In addition, 15 states and Puerto Rico offer low-income housing tax credit programs which are operated in a manner similar to the federal LIHTC program. Tax credits are authorized, government-sponsored incentives under federal and state tax codes designed to implement public policy. These tax credits support numerous purposes and in varying amounts. See **Table 4** for a list of federal and state tax credit programs that may be structured to provide investors a return comprised primarily of tax credits.

Table 4: Tax Credit Programs	
Federal	**State**
Low-income housing tax credits	Low-income housing tax credits
Historic tax credits	Historic tax credits
Qualified School Construction Bond	Brownfields tax credits
Tax credit for rehabilitation of structures other than historic structures	Angel investor tax credits
New market tax credits	New market tax credits
Renewable energy tax credits	Renewable energy tax credits
Work Opportunity tax credit	Film & TV tax credits
Tax credit for holders of Qualified Zone Academy Bonds	

Conclusions and Recommendations for Change

71. The increased use of equity investment structures by taxing authorities as a means of allocating tax credits under their various programs has resulted in increased use of equity investments where the tax credit investor has little participation in the underlying operations of the investee. We have referred to these types of investments as tax credit investments. Application of the equity method to tax credit investments distorts financial reporting of investment performance, which is confusing and potentially misleading to users of financial statements. To promote the transparency and usefulness of the financial statements, a new method of accounting for tax credit investments is needed.

72. The FASB's current project on accounting for financial instruments provides an opportunity to address the accounting for all types of tax credit investments which share similar characteristics. The current scope of the project on accounting for financial instruments will require consideration of tax credit investments structured as equity investments. Simply requiring all equity investments to be accounted for as financial instruments, perhaps measured at fair value, would ignore the unique nature and benefits of tax credit investments.

73. Under existing U.S. GAAP, owners of nonfinancial assets which qualify for government assistance in the form of ITC's and government grants account for those assets using various accounting methods which reflect the economic impact of the government assistance. In some cases, the impact of the government assistance is allowed to be reported as a pre-tax benefit or as a reduction of the cost of the asset, which effectively reduces future depreciation charges. In certain situations, ITC's related to direct financing leases can be included as a component of pre-tax income related to the lease.

74. The accounting for asset based government grants, which is addressed in International Accounting Standard 20, "Accounting for Government Grants and Disclosure of Government Assistance" (IAS 20), allows for government grants to be accounted for using one of two options: either as deferred income which is recognized in earnings over the life of the related asset; or as a reduction to the cost of the asset, which results in lower depreciation charges over the life of the asset. Both options have the same economic impact on the entity's pre-tax earnings.

75. Investors in tax credit equity investments are not able to utilize the accounting options available to investments in non-financial assets eligible for similar types of tax benefits. Rather, the accounting for tax credit equity investments, with the exception of investments qualifying for the effective yield method, is the same as the accounting for all other types of equity investments.

76. Affordable housing tax credit investments have different investment objectives than traditional real estate investments. Application of the equity method to account for affordable housing tax credit investments does not result in relevant or reliable financial information and distorts the financial reporting measurement of investment performance. Because affordable housing tax credit investments (and other similar tax credit investments) are principally purchases of tax credits, they need to be accounted for differently, perhaps as a component of the investor's income tax provision (as net tax benefits) and not as operating investments. Although the effective yield method accurately reflects qualifying affordable housing tax credit investments as a purchase of net tax benefits, the significant restrictions which must be met in order to qualify for its use prevent the effective yield method from being effective as a broad-based method of accounting for these investments.

Tax credit investment method of accounting

77. A new, more principles-based method of accounting is needed for affordable housing tax credit investments (and other similar tax credit investments). One that produces relevant and reliable financial information regarding investment performance and reflects the underlying nature and substance of the investment as a purchase of tax benefits. For illustrative purposes we have outlined a new method of accounting for tax credit investments, which is referred to herein as the "tax credit investment method" of accounting, and is described below. We recognize that the tax credit method of accounting is but one option and that the FASB will need to give full consideration to other alternatives in order to arrive at a

comprehensive solution that addresses the unique nature of all types of tax credit investments which share similar characteristics.

78. The tax credit investment method of accounting would apply to qualified equity investments which share similar characteristics and meet specific tax credit investment criteria (described below). Qualifying investments would be accounted for as purchases of tax benefits. Under the tax credit investment method, a proportionate amount of the cost of the investment would be amortized against the related tax credits and reported as a component of the tax credit investor's income tax provision. The amount of investment amortization recognized as a cost in each reporting period would be calculated as a percentage of the original investment based on the portion of tax credits received during the reporting period in comparison to the total tax credits expected to be received. In other words, investment costs would be recognized on a pro rata basis with the tax credits actually received.

79. In order to qualify for the tax credit investment method of accounting, an affordable housing tax credit investment (or other tax credit investment) would have to have substantially all of the following characteristics:

a. The investment is negotiated between non-taxing entities.

b. The investor is a limited partner (or investor member if an LLC) in the entity for both legal and tax purposes, and the investor's liability is limited to its capital account. The investor is not required to provide any subordinated financial support to the investee.

c. The investment enables the investor to receive tax benefits under a program explicitly permitted under a U. S. Internal Revenue Code section or similar statutes of a state taxing authority. The tax credit program specifies the conditions or criteria under which tax benefits are allocated and specifies the timing and amount of the tax benefits, resulting in certainty relating to the deductibility and timing[19] of the tax benefits. The amount of tax benefits available to the entity under the program is based on a fixed allocation which is not contingent[20] on or subject to future economic operating performance of the investee entity.

d. The investor's projected yield based solely on the cash flows from the tax benefits is expected to be positive.

e. The investment amount and expected return at the inception of the investment is, by design, based solely on the amount of tax benefits to be allocated to the investor and not on

[19] Uncertainty regarding the start of the tax benefits due to normal uncertainties regarding completion of construction would not be considered a lack of uncertainty with respect to the timing of the tax benefits.
[20] Requirements to maintain compliance with operating or use agreements in order to maintain eligibility under the tax program would not be considered a contingency.

other, non-tax benefit attributes of the investment. The investor's right to receive other, non-tax benefits from the entity is not designed (or expected) to be potentially significant.

Example

80. An example of the proposed tax credit method of accounting is illustrated in **Table 5** below.

Table 5: Example of Tax Credit Method

Year	Book Income (1)	Tax Income (Depreciation) (2)	Tax Credits (3)	Amortization of Investment (4)	Other Tax Benefit (5)	Current Tax Benefit (Expense) (6)	Deferred Tax Benefit (Expense) (7)	Net Income (Loss) (8)
1	$ -	$ (7,273)	$ 16,000	$ (10,000)	$ 2,909	$ 8,909	$ 1,091	$ 10,000
2	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
3	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
4	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
5	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
6	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
7	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
8	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
9	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
10	-	(7,273)	16,000	(10,000)	2,909	8,909	1,091	10,000
11	-	(7,273)	-	-	2,909	2,909	(2,909)	-
12	-	(7,273)	-	-	2,909	2,909	(2,909)	-
13	-	(7,273)	-	-	2,909	2,909	(2,909)	-
14	-	(7,273)	-	-	2,909	2,909	(2,909)	-
15	-	(7,273)	-	-	2,909	2,909	(2,909)	-
Totals	$ -	$ (109,091)	$ 160,000	$ (100,000)	$ 43,635	$ 103,635	$ (3,635)	$ 100,000

Example based on a $100,000 investment.
(1) Book income before taxes would not reflect any income or loss associated with the tax credt investment.
(2) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.
(3) 8 percent tax credit on $200,000 tax basis of the underlying assets.
(4) Investment in excess of estimated residual value (zero in this case) amortized in proportion to tax credits received in the current year to total estimated tax credits.
(5) (Column (2) x 40% tax rate).
(6) Column (3) + column (4) + column (5).
(7) The change in defered taxes resulting from the difference between the book and tax bases of the investment and tax losses in excess of the at-risk investment. In this example, that amount can be determined as follows: (column (4) - column (2)) x 40% tax rate.
(8) Column (1) + column (6) + column (7).

81. In **Table 6** annual investor reporting using the proposed tax credit method is compared to the equity method.

Table 6: Comparison of Investor Financial Reporting Using Proposed TCM versus Equity Method

Proposed TCM											
Year	1	2	3	4	5	6	7	8	9	10	Totals
Revenues	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 4,000,000
Operating expenses	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	2,000,000
Net operating income (loss)	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	2,000,000
Investment income	-	-	-	-	-	-	-	-	-	-	-
Income (loss) before taxes	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	2,000,000
Income tax expense	70,000	70,000	70,000	70,000	70,000	70,000	70,000	70,000	70,000	70,000	700,000
Net income	$ 130,000	$ 130,000	$ 130,000	$ 130,000	$ 130,000	$ 130,000	$ 130,000	$ 130,000	$ 130,000	$ 130,000	$ 1,300,000
Equity Method											
Year	1	2	3	4	5	6	7	8	9	10	Totals
Revenues	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 4,000,000
Operating expenses	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	2,000,000
Net operating income (loss)	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	2,000,000
Investment income (tax credit investment)	(7,273)	(7,273)	(7,273)	(7,273)	(7,273)	(7,273)	(8,362)	(16,000)	(16,000)	(16,000)	(100,000)
Income (loss) before taxes	192,727	192,727	192,727	192,727	192,727	192,727	191,638	184,000	184,000	184,000	1,900,000
Income tax expense	61,091	61,091	61,091	61,091	61,091	61,091	60,654	57,600	57,600	57,600	600,000
Net income	$ 131,636	$ 131,636	$ 131,636	$ 131,636	$ 131,636	$ 131,636	$ 130,984	$ 126,400	$ 126,400	$ 126,400	$ 1,300,000

Note that the revenues and operating expenses are those of the investor and that the impact of the tax credit investment is reflected in the income tax expense under the Proposed TCM and in the Investment income (tax credit investment) and Income tax expense lines under the Equity Method.
The information in Table 6 is based on the Example in Appendix E.

Appendix A – LIHTC Overview

General

A1. Affordable housing developments lease rental units to low-income individuals at below-market rental rates. As a result, these properties would generally fail to attract private investment without government intervention due to low yields relative to the risk involved. The Low-Income Housing Tax Credit ("LIHTC") program, created as part of the Tax Reform Act of 1986 and provided for in Section 42 of the Internal Revenue Code ("IRC"), is an indirect subsidy that encourages investment in the development or renovation of affordable rental housing for the benefit of low-income individuals. The LIHTCs are earned over a period of 15 years (the "Compliance Period"). However, an investor may claim equal amounts of tax credits over 10 years in return for investing capital in qualified affordable housing projects. The invested capital reduces the amount of debt required to finance the development and ultimately the needed cash flow to support operations and debt service.

A2. Administration of the LIHTC program is delegated to the states and each state is allocated a certain amount of annual tax credit allocation authority, which is stipulated in IRC Section 42. The state agency, acting under federal guidelines, is responsible for creating a qualified allocation plan ("QAP") that prioritizes the allocation of these credits to serve the greatest housing needs of the state. The QAP provides the basis for which the state will allocate the tax credits to qualifying low-income projects. A project owner, usually a developer, must apply for an allocation of LIHTC by proposing a rental development that complies with the guidelines set out in the QAP. After reviewing all applications, the state agency will award the best applicants with an allocation of annual tax credits.

Minimum Requirements

A3. The project owner must agree to certain requirements in order to be awarded an allocation of LIHTCs. These requirements include committing units to be "set-aside" at certain income limits, rent restrictions, and maintaining the project as low-income for an extended use period. The available minimum set-asides are:

- At least 20% of the units must be occupied by households whose income is 50% or less of the area median gross income, adjusted for the size of the household.
- At least 40% of the units must be occupied by households whose income is 60% or less of the area median gross income, adjusted for the size of the household.

A4. Rents and utility costs may not exceed 30% of the income limitation in the selected set-aside. These rent restrictions assume a family size as being 1.5 persons per bedroom of each LIHTC unit. Finally, a successful applicant will enter into a Land Use Restriction Agreement ("LURA") with the state agency. Among other things, the LURA requires the owner to adhere to the aforementioned affordability requirements for a minimum of 15 years beyond the Compliance Period.

A5. The application process can be very competitive since the state agencies have a limited amount of credits to allocate to qualifying projects. Therefore, the project's owner will usually commit a larger percentage of the project to be subjected to deeper rent restrictions, income limitations, and/or extended use periods. Failure to comply with the minimum requirements that was selected by the project owner, throughout the Compliance Period, results in recapture of a portion of the credits.

The Tax Credits

A6. The project owner can apply for two types of LIHTCs which are generally referred to as 9% credits and 4% credits. Developments that qualify for 9% credits must be new construction or a substantial rehabilitation of an existing project that is to be financed with a conventional construction loan. These same projects will qualify for the 4% credit if they are financed with tax-exempt bonds and/or other federal subsidies[21]. The acquisition basis of an existing project that is to be substantially rehabilitated also qualifies for the 4% credit, regardless of the type of financing.

A7. The actual credit amount is determined on a building-by-building basis from certain developmental costs, the percentage of the project set-aside for low-income housing, and the applicable tax credit percentage. Eligible basis includes total development expenses less costs for land, most off-site improvements, commercial space, permanent financing fees, intangible assets, reserves, syndication costs, and other soft costs. A project owner may receive a 30% increase in eligible basis if it is located in a Qualified Census Tract ("QCT") or Difficult Development Area ("DDA"). DDAs are determined annually by the U.S Department of Housing and Urban Development and QCTs are defined in IRC Section 42 as census tracts "in which 50% or more of the households have an income which is less than 60% of the area gross median income or which has a poverty rate of at least 25%". This additional incentive may not be applied to the basis for acquisition of an existing building.

A8. The applicable fraction of each building is the lesser of the low-income units or square footage set-aside as a percentage of the total building. Qualified basis is equal to the eligible basis (and basis increase for projects in a QCT or DDA) multiplied by the applicable fraction. The project owners will frequently set-aside 100% of the units as low-income in order to maximize the amount of LIHTCs allocated to each building of the development. Finally, the qualified basis is multiplied by the applicable tax credit percentage in order to calculate the annual tax credit (see Example Calculations 1A and 1B below).

Example 1A – 9%		***Example 1B – 4%***	
Eligible Basis	$10,000,000	Eligible Basis	$10,000,000
x DDA/QCT	130%	x DDA/QCT	130%
Adjusted Basis	13,000,000	Adjusted Basis	13,000,000
x Applicable Fraction	50%	x Applicable Fraction	50%
Qualified Basis	6,500,000	Qualified Basis	6,500,000
x Tax Credit Percentage	9%	x Tax Credit Percentage	4%
Annual LIHTC	$ 585,000	Annual LIHTC	$ 260,000

A9. The state agency may allocate an amount of tax credits that is less than the calculation above for various reasons. These reasons may include an exclusion from eligible basis of contractor or developer fees that are in excess of certain limitations prescribed in the QAP. In addition, the allocation

[21] Rent subsidies generally do not affect the LIHTC rate.

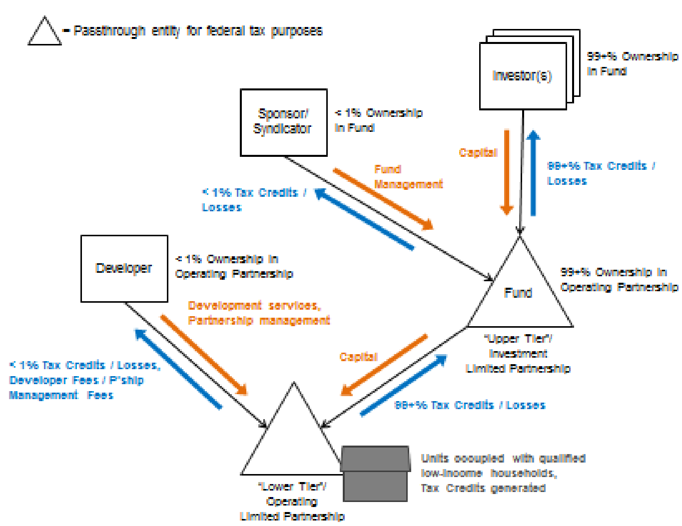
may be limited to the amount of tax credits that are required to generate the equity needed to make the project financially feasible, which is commonly referred to as the equity gap. Regardless of the reasoning, the project owner may only claim the amount of annual LIHTCs that are allocated to the project.

Typical Investment Structures

A10. LIHTC projects produce benefits from the awarded tax credits and taxable losses from depreciation and interest expense. A limited partnership or limited liability company is usually created as the owner of the project (the "Operating Entity"), with the developer acting as the general partner or managing member. The developer will often sell at least a 99% ownership interest in the Operating Entity. The developer is willing to do so in order to create the necessary equity to finance the construction of the development. The developer may also earn various management fees in their capacity as the general partner.

A11. Investors can invest directly in low-income projects, but will normally indirectly invest in several Operating Entities through a syndicator. A syndicator acquires and combines an interest in multiple low-income projects into a separate pass-through entity (the "Fund"). Then, the syndicator will sell at least a 99% ownership interest in the Fund to investors. Therefore, the investors receive the majority of the tax benefits generated from the Operating Entity and the syndicator earns a management/syndication fee (See Illustration 1, below).

Illustration 1



A12. LIHTC projects customarily operate at break-even from a cash flow perspective. After considering the impact of depreciation expense, LIHTC projects typically operate at a net loss. The Operating Entity and Fund are carefully structured such that residual cash flows will be directed to the general partner in the form of partnership fees or other fees. Additionally, many projects require funding of "soft", or cash flow contingent, loans from States or other entities. Such loans are to be repaid from cash flows from operations. Due to the general partner's rights to receive fees and the existence of "soft" loans, the limited partners generally do not expect to receive significant cash flow from the eventual disposition of the project. Therefore, the cost of a limited partner interest acquired by the investor is derived mainly from its investment in the tax benefits that are generated.

A13. The tax benefits to be claimed by the investor are realized over time, but the equity contribution is made up-front. Therefore, the investor's capital is at risk from development cost overages, default risk/foreclosure from the debt that is secured by the project, and the risk of tax credit recapture. The general partner of the affordable housing tax credit property entity commonly provides various guaranties to secure the investor's return. These guaranties frequently consist of the following:

- Construction Completion Guaranty – a guarantee to provide additional funding to complete the construction of the project, if necessary.
- Operating Deficit Guaranty – a guarantee to provide any necessary operating advances to the project to ensure timely payments of debt service and to support continuing operations.
- Tax Credit Adjuster Guaranty – a guarantee to compensate the limited partner for any reduction in the actual tax credits allocated. The actual amount of this potential guarantee is usually based on a pre-determined formula and its purpose is to restore the investor's return in the event that the expected amount of tax credits is not realized.

Appendix B – NMTC Overview

General

B1. Community Development Entities ("CDE") use their local knowledge and expertise to invest, by providing equity or below market-rate loans, in Qualified Active Low-Income Community Businesses ("QALICB"). Generally, a QALICB is a business that operates in a low-income community. Typical QALICBs include small technology firms, inner-city shopping centers, manufacturers, retail stores or micro-entrepreneurs. These businesses would generally fail to attract private investment without government intervention due to low yields and significant default risks. The New Markets Tax Credit ("NMTC") program, created by Congress during 2000 and provided for in Section 45D of the Internal Revenue Code ("IRC"), is an indirect subsidy that encourages private sector investments in low-income communities. The NMTCs are earned over a period of 7 years (the "Compliance Period").

B2. Administration of the NMTC program is performed by the Community Development Financial Institutions Fund ("CDFI Fund"), and IRC Section 45D permits a limited amount of allocation authority. The CDFI Fund, under federal guidelines, is responsible for prioritizing the allocation of these credits to serve the greatest low-income development needs of the nation. A CDE must apply to the CDFI Fund for an award of NMTCs. After reviewing all applications, the CDFI Fund will award the best applicants with an allocation of tax credits. The CDE then raises capital by seeking Qualified Equity Investments ("QEI") from taxpayers that want to receive NMTCs, and provides Qualified Low-Income Community Investments ("QLICI") to the QALICBs.

Minimum Requirements

B3. An entity must be certified as a CDE in order to submit a NMTC allocation application. A CDE can be a corporation, partnership or LLC taxed as a corporation or partnership for federal income tax purposes. It cannot be a single member LLC disregarded for federal income tax purposes but can be a nonprofit or for-profit entity. An entity can only be a CDE if the following three conditions are met:

1. The primary mission of the entity is serving or providing investment capital for low-income communities or low-income persons.
2. The entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity.
3. The entity is certified by the Secretary for purposes of Section 45D as being a CDE.

B4. A QLICI consists of the following:

1. Any capital or equity investment in, or loan to, any QALICB.
2. The purchase from another CDE of any loan made by such entity that is a QLICI.
3. Financial counseling and other services to businesses located in, and residents of, low-income communities.
4. Certain equity investments in, or loans to, a CDE.

B5. A QALICB is a corporation or a partnership for the taxable year if the following conditions exist:

1. At least 50% of the total gross income of the entity is derived from the active conduct of a qualified business within any low-income community.
2. At least 40% of the tangible property of the entity is used within any low-income community.
3. At least 40% of the services performed for the entity by its employees are performed in any low-income community.
4. Less than 5 percent of the average of aggregate unadjusted bases of the property of the entity is attributable to certain collectibles
5. Less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain nonqualified financial property.

B6. A low-income community means any population census tract if:

1. The poverty rate for such tract is at least 20%;
2. In the case of a tract not located within a metropolitan area, the median family income for such tract does not exceed 80% of statewide median family income;
3. In the case of a tract located within a metropolitan area, the median family income for such tract does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income.

B7. CDEs are required to use substantially all of the QEIs to make QLICIs into QALICBs located in low-income communities. The requirement to use “substantially all” is met if at least 85% of the taxpayer's QEI is directly traceable to QLICIs. This threshold drops to 75% for year seven of the Compliance Period.

The Tax Credits

B8. The NMTC is a 39 percent federal tax credit available to investors over seven periods spanning six years and one day. The actual credit amount is determined from the amount of each QEI and the applicable percentage for the respective credit allowance date. According to IRC Section 45D, the applicable percentage is 5% for the first three credit allowance dates and 6% for the remainder. The credit allowance dates are: (1) the date on which the investment is initially made; and (2) each of the six anniversary dates thereafter. Each QEI has its own credit allowance dates.

Example 1: The CDFI Fund allocates a CDE the right to issue $100 million in credit-qualifying equity investments. The CDE raises $50 million in cash equity to be used for investments in QALICBs. Assuming all other requirements are met, the investors receive $2.5 million in tax credits for each of the first three years and $3 million in tax credits for each of the last four years. While the CDE has the authority to issue as much as $100 million in QEIs, its investors can only claim NMTCs on the actual cash invested in the CDE.

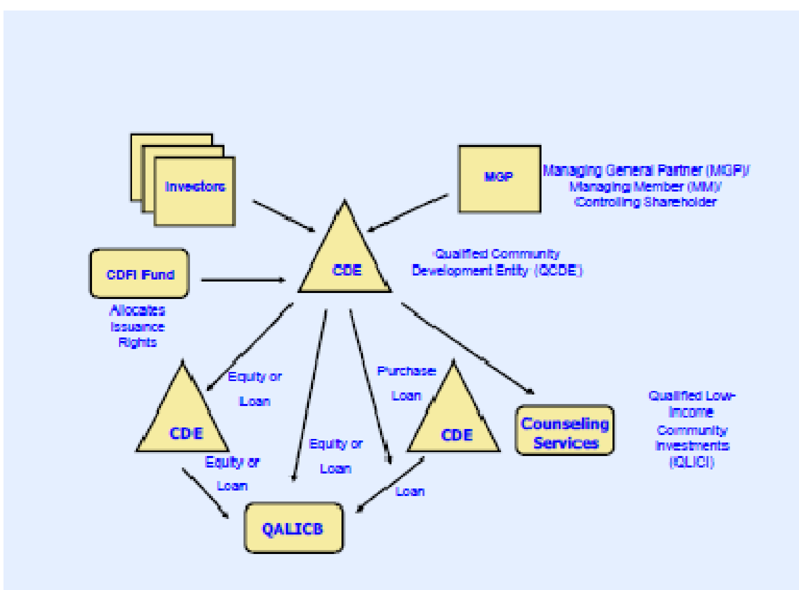
Year 1	5%	$2,500,000
Year 2	5%	$2,500,000
Year 3	5%	$2,500,000
Year 4	6%	$3,000,000
Year 5	6%	$3,000,000
Year 6	6%	$3,000,000
Year 7	6%	$3,000,000
Total	**39%**	**$19,500,000**

Typical Investment Structures

B9. NMTCs are available to a taxpayer that holds a QEI on a credit allowance date. The Treasury has interpreted taxpayer as a federal income tax recognized entity, which provides that a taxpayer may include individuals, corporations, partnerships and investment funds.

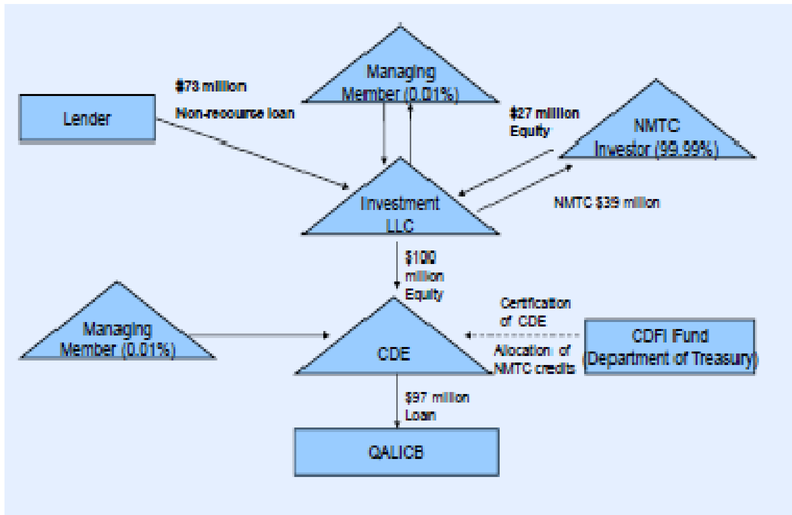
B10. Illustration 1 depicts what is known as a non-leveraged structure. In this structure, an investor will make a QEI directly into a CDE. The CDE then uses the QEI to entirely fund its investments (See Illustration 1 below).

Illustration 1



B11. Illustration 2 depicts what is known as a leveraged structure. Instead of investing directly, as demonstrated in Illustration 1, the investors contribute equity to a partnership or limited liability company ("Investment LLC"). The Investment LLC then uses the equity installment and loan proceeds to make a QEI to the CDE (See Illustration 2 below).

Illustration 2



Appendix C – Historic Tax Credits Overview

General

C1. A certified historic structure is defined as a building contained in the Department of the Interior's National Park Service Division's National Register of Historic Places ("NPS"), and is designated as being of historic significance to the district, or is located in a certified historic district. The historic rehabilitation tax credit program is an indirect federal subsidy created to incentivize private developers and investors to restore older and historic buildings to productive use. The program serves as a much needed tool for those whose goal is to restore old, dilapidated buildings and bring them back to commercial viability. It has been effective in revitalizing distressed areas through the fostering of private sector investment, providing a strong alternative to government ownership and management of historic properties, creating jobs and renewed commerce to the historic cores of cities and towns, increasing property values in these areas, and helping create additional alternatives for affordable housing.

C2. The historic tax credit program is administered by the NPS, the Internal Revenue Service ("IRS") and state historic preservation offices ("SHPO"). The federal historic rehabilitation tax credit ("HTC") was originally enacted as a part of the Revenue Act of 1978 and was later modified as a part of the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986. As a result of changes made by the Revenue Reconciliation Act of 1990, the HTC rules are now outlined in section 47 of the Internal Revenue Code ("IRC").

C3. The HTC applies to costs incurred for the renovation, restoration and reconstruction of historic buildings. In order to qualify for the HTC, owners must complete the Historic Preservation Certification Application and the project must meet the Secretary of the Interior's standards for rehabilitation.

Minimum Requirements

C4. IRC section 47 provides for two types of rehabilitation tax credits:

1. The 20 percent credit is a credit equal to 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure.
2. The 10 percent credit is a credit equal to 10 percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure. In order to qualify for the 10 percent credit, the building must have been first placed in service before 1936.

C5. The responsibility of certifying whether an historic building rehabilitation project will be eligible for the HTC has been delegated to the NPS. In the case of the 20 percent credit, the building must be a certified historic structure and the rehabilitation itself must be certified. In the case of the 10 percent credit available to pre-1936 buildings located in a historic district listed in the National Register, the NPS must certify that the building does not contribute to the historic nature of the area; in this situation, the rehabilitation itself does not need NPS certification. Also, NPS usually defers certain decisions as to whether a particular building contributes to the historic nature of an area to the governing state preservation office.

C6. The HTC is generally claimed in the year of the rehabilitation of the underlying building is place in service. After the rehabilitation expenditures are placed in service, the building must remain in productive use and the entity owning the building must not change ownership for a period of five years, or recapture of all or part of the credit is required.

The Tax Credits

C7. In order for a potential building rehabilitation to qualify for the HTC, many factors must be considered before rehabilitation begins and, in some cases, before the potential rehabilitation building project is purchased. The five major criteria are:

1. The building must be a qualified rehabilitated building.
2. If the 20 percent credit is sought, the rehabilitation, both in the planning and in the final product, must be certified as eligible by the NPS.
3. The rehabilitation must be substantial.
4. The expenditures included in the basis upon which the credit is calculated must be qualified rehabilitation expenditures.
5. The credit must be properly reported to the IRS by the taxpayer and the NPS.

C8. Determining which credit applies is important. The IRS first determines whether the 20 percent credit is available. If the building qualifies as subject to the 20 percent credit, the taxpayer must claim the 20 percent credit or no credit at all. A taxpayer cannot claim the 10 percent on a certified historic structure except under the following circumstances:

1. The building itself is not a certified historic structure,
2. The NPS certifies to the Secretary of the Treasury that such building is not of historic significance to the district, and
3. If the certification described in (b) occurs after the beginning of the start of the rehabilitation of a building, the taxpayer must certify to the IRS that, at the beginning of the rehabilitation, the taxpayer, in good faith was not aware of the requirements referred to in (b).

Typical Investment Structures

C9. Generally, the historic rehabilitation tax credit can be claimed by any taxpayer that is directly liable for federal income tax such as individuals, C corporations, and in certain circumstances, estate and trusts. Taxpayers that are not directly liable for federal income tax include pass-through entities, such as partnerships, limited liability companies taxed as partnerships and S corporations. Although these entities cannot claim the credit directly, a pass-through entity can own an historic tax credit qualified building that generates HTCs. The entity can pass the HTC to its owners who may be directly liable for federal income tax. In fact, the majority of HTC properties are owned by pass-through entities because of other tax considerations.

C10. Exempt organizations generally are not subject to federal income tax; therefore, they cannot claim or use the HTC.

Appendix D – Renewable Energy Investment Tax Credit Overview

General

D1. The United States Congress initially created investment tax credits ("ITC") in 1962 to stimulate the economy and to protect domestic business from foreign competition. The Revenue Reconciliation Act of 1990 expanded the ITC to include a 10% energy credit, and during 2005 Internal Revenue Code ("IRC") Section 48, as part of the Energy Act, was amended to provide for a 30% investment tax credit on qualifying energy property. The energy property that is the subject of this overview includes equipment, such as solar panels, which use solar energy to create electricity. Developers sell solar energy investment tax credits ("Solar Credits") to investors to secure equity that may be used to finance the purchase and installation of the solar energy panels.

D2. Companies developing renewable energy sources from solar technology are generally involved in the business of developing alternative energy solutions for end users seeking a more cost effective means of procuring energy for their own use. Typically, the energy user, known as the "off-taker", does not have the capital required to finance the installation of the solar panels. Solar developers create value by sourcing the relationship with the off-taker in addition to carrying out the physical process of installing solar energy panels at the site. Solar developers are also responsible for negotiating power purchase agreements (or lease agreements) with off-takers to establish the rates per kilowatt hour of electricity such users will pay for electricity generated by the solar panels. As part of the overall development/installation process, developers work to secure rebates from local utilities in return for purchasing and operating the solar panels for an agreed-upon period. Developers also work to secure whatever other rebates or subsidies are available from a particular state or municipality.

Minimum Requirements

D3. The solar tax credit program is governed by IRC Section 48. Owners of these projects generally create a pass-through entity (the " Operating Partnership") to develop, own and maintain the qualifying energy property. The Operating Partnership is eligible to claim investment tax credits in the year the project is placed in service, but the project must maintain compliance with IRC Section 48 for a period of 5 years to avoid credit recapture.

D4. The term "energy property" means any property:

1. Which is:
    a. Equipment which uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat, excepting property used to generate energy for the purposes of heating a swimming pool,
    b. Equipment which uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight but only with respect to periods ending before January 1, 2017,

   c. Qualified fuel cell property,
   d. Combined heat and power system property.
2. Including:
   a. The construction, reconstruction, or erection of which is completed by the taxpayer, or
   b. Which is acquired by the tax payer if the original use of such property commences with the taxpayer
3. With respect to which depreciation is allowable, and
4. Which meets the performance and quality standards (if any) which:
   a. Have been prescribed by the Secretary by regulations, and
   b. Are in effect at the time of the acquisition of the property.

The Tax Credits

D5. Generally, the property acquired, developed or installed for solar tax credit projects qualifies for an energy percentage of 30% which is used to determine the amount of tax credits for a taxable year. The solar tax credits are available to the Operating Partnership upon the place in service date of the project. The actual credit amount is determined by multiplying the Operating Partnership's basis in energy property multiplied by the energy percentage of 30%.

Example 1: Suppose a photovoltaic project is placed in service for $400,000. The solar panel installation cost is $325,000, and additional installation costs of $75,000 are incurred. This project will generate a total of $120,000 ($400,000 x 30%) ITCs. The project owner could court an investor to purchase an interest in the entity. If the investor purchases a 99 percent interest, he will be able to claim ITCs in the amount of $118,800 ($120,000 x 99%).

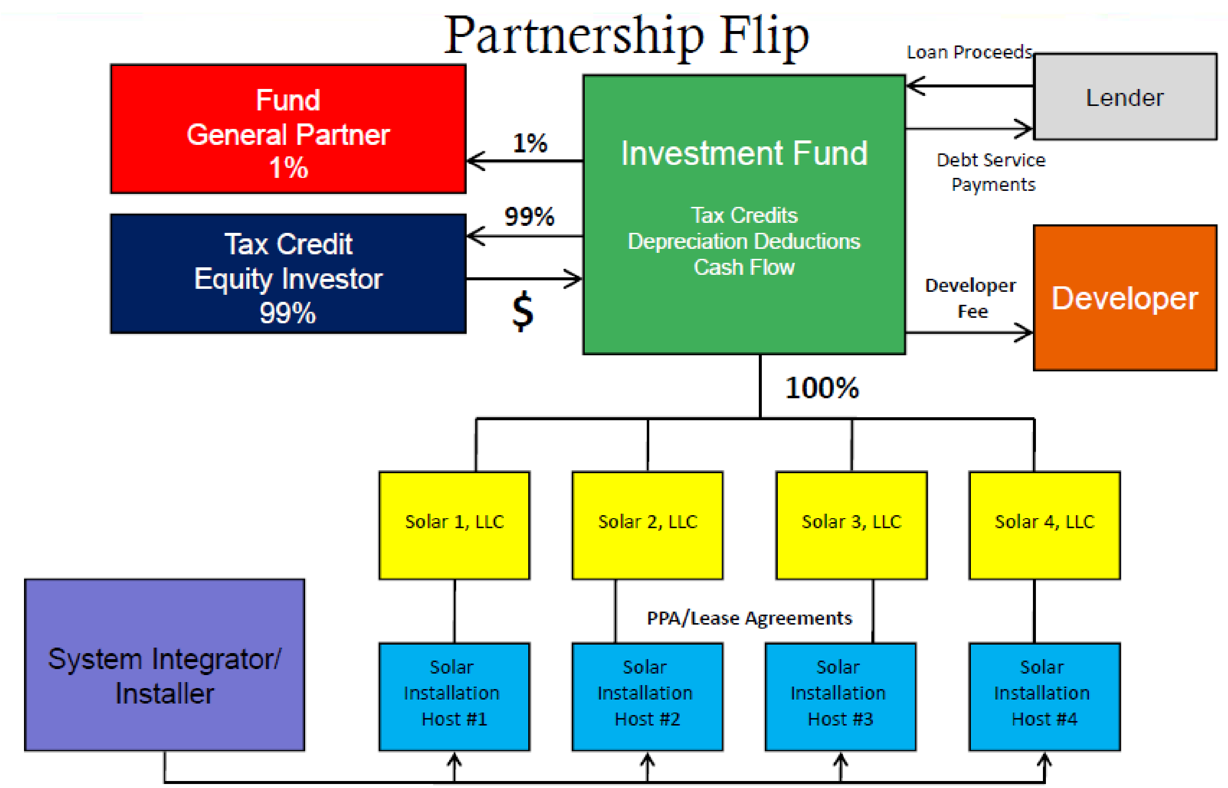
Typical Investment Structures

D6. In general, the ITC can be claimed by any taxpayer that is directly liable for federal income tax. Taxpayers who are directly liable for federal income tax include individuals, C corporations and, in certain circumstances, estates and trusts.

D7. Taxpayers that are not directly liable for federal income tax include pass-through entities, such as partnerships, limited liability companies taxed as partnerships, and S corporations. Although these entities cannot claim the credits directly, a pass-through entity can own a facility that qualifies for the ITC, generate the credits and pass the credits through to its owners who may be directly liable for federal income tax. In fact, the majority of ITC facilities are owned by pass-through entities because of other tax and structuring considerations.

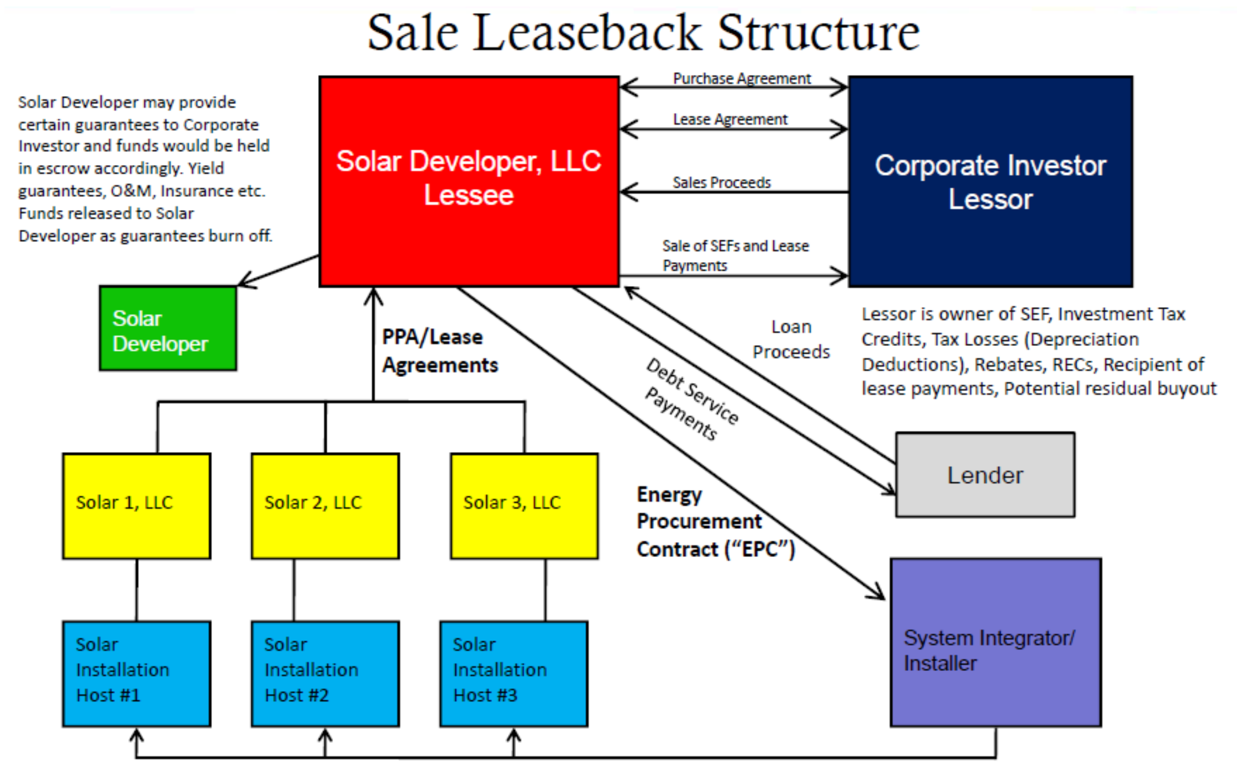
D8. Illustration 1 depicts what is known as a partnership flip structure. In this structure, an investor will make an investment directly into an investment fund. The investment fund then uses the investment to entirely fund its investments (See Illustration 1 below). At the end of a specified period (generally 5 to 7 years), the percentage interests of the Tax Credit Equity Investor and the Fund General Partner flip, so that the Fund General Partner has the majority ownership interest and will commence the buyout of the Tax Credit Equity Investor based on her smaller ownership percentage.

Illustration 1



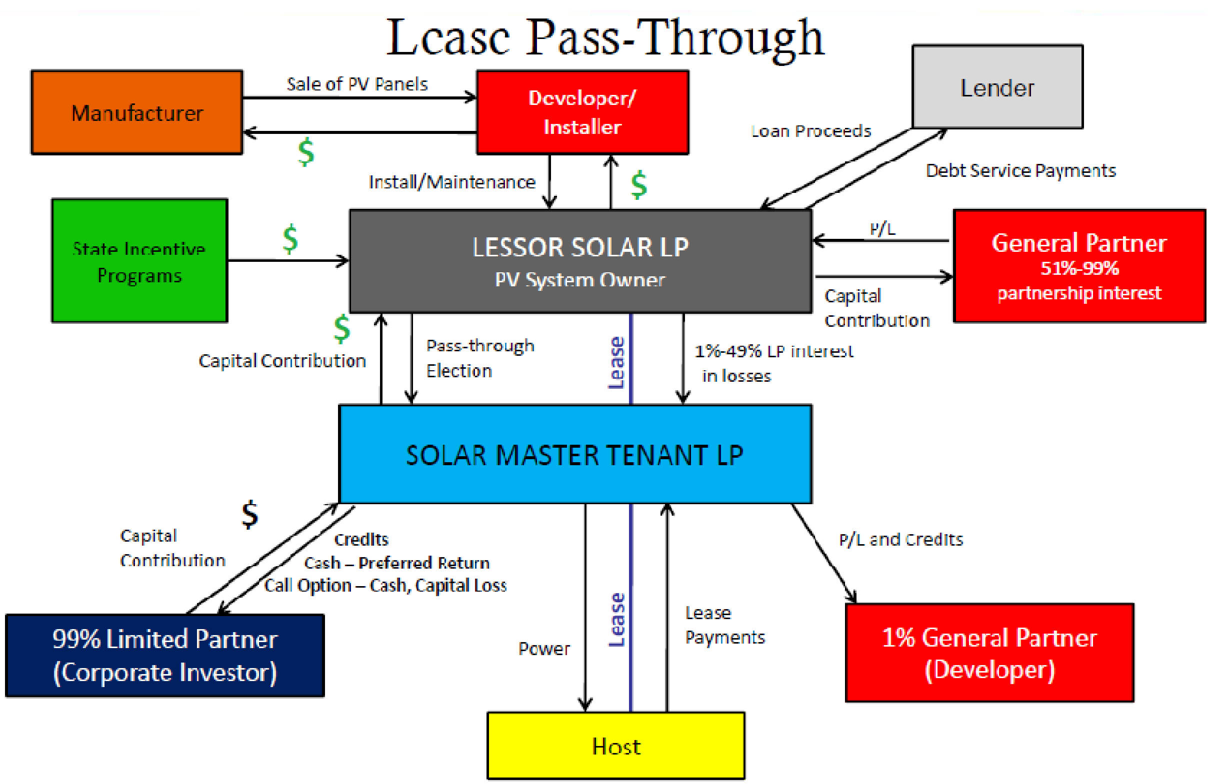
D9. Illustration 2 depicts what is known as a sale leaseback structure. Instead of investing directly, as demonstrated in Illustration 1, the investors purchase the qualifying solar system from the developer and immediately lease the system back to the developer. The developer/lessee is required to pay fixed rent back to the investor for the term of the lease regardless of system performance (See Illustration 2 below). At the end of a specified period, the developer/lessee owns the system through a purchase option. The purchase option may be a bargain purchase, but generally is at fair market value.

Illustration 2



D10. Illustration 3 depicts what is known as a lease pass-through structure. The statute allows the energy property owner and lessor to "pass through" all or a portion of the ITC to a lessee, as long as the lessor is not a tax-exempt entity (See Illustration 3 below). At the end of a specified period (generally 6 years) and after the receipt of the majority, if not all, of the tax credits, the Developer will buyout the Limited Partner of the Lessee through a put option, call option or flip.

Illustration 3



Appendix E – LIHTC Examples

Assumptions

E1. Examples of the current methods of accounting for affordable housing tax credit investments (cost method, equity method, effective yield method, and fair value method) are presented in this Appendix E. The examples are all based on the same assumptions which are summarized below.

a. All cash flows (except initial investment) occur at the end of each year.
b. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).
c. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.
d. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.
e. The annual tax credit allocation (equal to 8 percent of the project's original cost) will be received for a period of 10 years.
f. The investor's tax rate is 40 percent.
g. The project will operate with break-even pre-tax cash flows including debt service during the first 15 years of operations.
h. The project's taxable and book loss will be equal to depreciation expense. The cumulative book loss recognized by the investor under the equity method of accounting is limited to the $100,000 investment.
i. Deferred taxes are provided for the difference between the book and tax bases of the investment. Deferred taxes are provided for losses in excess of the at-risk investment.
j. The investor will maintain the investment for 15 years (so there will be no recapture of tax credits).
k. The investor expects that the estimated residual value of the investment will be zero.
l. Under the effective yield method, a letter of credit or similar guarantee exists to qualify the investment for the use of the effective yield method.

E2. Income statement information is presented below which compares each method on an annual basis for each of the ten years during which the tax credits are received. The information related to the affordable housing tax credit investment for each method is based on separate calculations in the attached schedules, as described below:

- Schedule 1 Cash Flow Analysis
- Schedule 2 Cost Method
- Schedule 3 Equity Method
- Schedule 4 Effective Yield Method
- Schedule 5 Fair Value Method

E3. The separate schedules referred to above are presented immediately following the income statement comparisons.

INCOME STATEMENT

Current Method

	1				2				3			
	Cost Method	Equity Method	Eff. Yield Method	Fair Value Method	Cost Method	Equity Method	Eff. Yield Method	Fair Value Method	Cost Method	Equity Method	Eff. Yield Method	Fair Value Method
Revenues	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000
Operating expenses	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000
Income (loss) from operations	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000
Other income (loss)												
Equity in income (loss) of investment / amortization of investment	(10,000)	(7,273)	-	(10,000)	(10,000)	(7,273)	-	(10,000)	(10,000)	(7,273)	-	(10,000)
Impairment of investment	-	-	-	-	-	-	-	-	-	-	-	-
Net other income (loss)	(10,000)	(7,273)	-	(10,000)	(10,000)	(7,273)	-	(10,000)	(10,000)	(7,273)	-	(10,000)
Income (loss) before taxes	190,000	192,727	200,000	190,000	190,000	192,727	200,000	190,000	190,000	192,727	200,000	190,000
Tax expense	60,000	61,091	67,836	60,000	60,000	61,091	68,205	60,000	60,000	61,091	68,609	60,000
Net income (loss)	$ 130,000	$ 131,636	$ 132,164	$ 130,000	$ 130,000	$ 131,636	$ 131,795	$ 130,000	$ 130,000	$ 131,636	$ 131,391	$ 130,000

INCOME STATEMENT

Current Method

	4				5				6			
	Cost Method	**Equity Method**	**Eff. Yield Method**	**Fair Value Method**	**Cost Method**	**Equity Method**	**Eff. Yield Method**	**Fair Value Method**	**Cost Method**	**Equity Method**	**Eff. Yield Method**	**Fair Value Method**
Revenues	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 400,000
Operating expenses	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000
Income (loss) from operations	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000	200,000
Other income (loss)												
Equity in income (loss) of investment / amortization of investment	(10,000)	(7,273)	-	(10,000)	(10,000)	(7,273)	-	(10,000)	(10,000)	(7,273)	-	(10,000)
Impairment of investment	-	-	-	-	-	-	-	-	-	-	-	-
Net other income (loss)	(10,000)	(7,273)	-	(10,000)	(10,000)	(7,273)	-	(10,000)	(10,000)	(7,273)	-	(10,000)
Income (loss) before taxes	190,000	192,727	200,000	190,000	190,000	192,727	200,000	190,000	190,000	192,727	200,000	190,000
Tax expense	60,000	61,091	69,052	60,000	60,000	61,091	69,537	60,000	60,000	61,091	70,069	60,000
Net income (loss)	$ 130,000	$ 131,636	$ 130,948	$ 130,000	$ 130,000	$ 131,636	$ 130,463	$ 130,000	130,000	131,636	129,931	130,000

INCOME STATEMENT

Current Method

	7			
	Cost Method	**Equity Method**	**Eff. Yield Method**	**Fair Value Method**
Revenues	$ 400,000	$ 400,000	$ 400,000	$ 400,000
Operating expenses	200,000	200,000	200,000	200,000
Income (loss) from operations	200,000	200,000	200,000	200,000
Other income (loss)				
Equity in income (loss) of investment / amortization of investment	(10,000)	(7,273)	-	(10,000)
Impairment of investment	-	(1,091)	-	-
Net other income (loss)	(10,000)	(8,364)	-	(10,000)
Income (loss) before taxes	190,000	191,636	200,000	190,000
Tax expense	60,000	60,655	70,652	60,000
Net income (loss)	$ 130,000	$ 130,982	$ 129,348	$ 130,000

	8			
	Cost Metod	**Equity Method**	**Eff. Yield Method**	**Fair Value Method**
Revenues	$ 400,000	$ 400,000	$ 400,000	$ 400,000
Operating expenses	200,000	200,000	200,000	200,000
Income (loss) from operations	200,000	200,000	200,000	200,000
Other income (loss)				
Equity in income (loss) of investment / amortization of investment	(10,000)	(7,273)	-	(10,000)
Impairment of investment	-	(8,727)	-	-
Net other income (loss)	(10,000)	(16,000)	-	(10,000)
Income (loss) before taxes	190,000	184,000	200,000	190,000
Tax expense	60,000	57,600	71,291	60,000
Net income (loss)	$ 130,000	$ 126,400	$ 128,709	$ 130,000

	9			
	Cost Method	**Equity Method**	**Eff. Yield Method**	**Fair Value Method**
Revenues	$ 400,000	$ 400,000	$ 400,000	$ 400,000
Operating expenses	200,000	200,000	200,000	200,000
Income (loss) from operations	200,000	200,000	200,000	200,000
Other income (loss)				
Equity in income (loss) of investment / amortization of investment	(10,000)	(7,273)	-	(10,000)
Impairment of investment	-	(8,727)	-	-
Net other income (loss)	(10,000)	(16,000)	-	(10,000)
Income (loss) before taxes	190,000	184,000	200,000	190,000
Tax expense	60,000	57,600	71,991	60,000
Net income (loss)	$ 130,000	$ 126,400	$ 128,009	$ 130,000

INCOME STATEMENT

Current Method

	10				Total			
	Cost Method	Equity Method	Eff. Yield Method	Fair Value Method	Cost Method	Equity Method	Eff. Yield Method	Fair Value Method
Revenues	$ 400,000	$ 400,000	$ 400,000	$ 400,000	$ 4,000,000	$ 4,000,000	$ 4,000,000	$ 4,000,000
Operating expenses	200,000	200,000	200,000	200,000	2,000,000	2,000,000	2,000,000	2,000,000
Income (loss) from operations	200,000	200,000	200,000	200,000	2,000,000	2,000,000	2,000,000	2,000,000
Other income (loss)								
Equity in income (loss) of investment / amortization of investment	(10,000)	(7,273)	-	(10,000)	(100,000)	(72,727)	-	(100,000)
Impairment of investment	-	(8,727)	-	-	-	(27,273)	-	-
Net other income (loss)	(10,000)	(16,000)	-	(10,000)	(100,000)	(100,000)	-	(100,000)
Income (loss) before taxes	190,000	184,000	200,000	190,000	1,900,000	1,900,000	2,000,000	1,900,000
Tax expense	60,000	57,600	72,759	60,000	600,000	600,000	700,000	600,000
Net income (loss)	$ 130,000	$ 126,400	$ 127,241	$ 130,000	$ 1,300,000	$ 1,300,000	$ 1,300,000	$ 1,300,000

Schedule 1

Cash Flow Analysis

The investor's cash flow analysis follows.

Year	Purchase of Investment (1)	Tax Depreciation (2)	Tax Credit (3)	Taxes Saved (4)	Cash Saved (Spent)
1	$ 100,000				$ (100,000)
1		$ 7,273	$16,000	$ 18,909	18,909
2		7,273	16,000	18,909	18,909
3		7,273	16,000	18,909	18,909
4		7,273	16,000	18,909	18,909
5		7,273	16,000	18,909	18,909
6		7,273	16,000	18,909	18,909
7		7,273	16,000	18,909	18,909
8		7,273	16,000	18,909	18,909
9		7,273	16,000	18,909	18,909
10		7,273	16,000	18,909	18,909
11		7,273		2,909	2,909
12		7,273		2,909	2,909
13		7,273		2,909	2,909
14		7,273		2,909	2,909
15		7,273		2,909	2,909
Total		$ 109,095	$160,000	$ 203,635	$ 103,635

Internal rate of return based on tax credits only

(1) Assumed investment for a 5 percent limited partnership interest in the project.

(2) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.

(3) 8 percent tax credit on $200,000 tax basis of the underlying assets.

(4) (Column (2) x 40% tax rate) + column (3).

Schedule 2

Cost Method

Year	Net Investment (1)	Amortization of Investment (2)	Tax Depreciation (3)	Tax Credit (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
1	$ 90,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
2	80,000	10,000	7,273	16,000	18,909	1,091	10,000
3	70,000	10,000	7,273	16,000	18,909	1,091	10,000
4	60,000	10,000	7,273	16,000	18,909	1,091	10,000
5	50,000	10,000	7,273	16,000	18,909	1,091	10,000
6	40,000	10,000	7,273	16,000	18,909	1,091	10,000
7	30,000	10,000	7,273	16,000	18,909	1,091	10,000
8	20,000	10,000	7,273	16,000	18,909	1,091	10,000
9	10,000	10,000	7,273	16,000	18,909	1,091	10,000
10	-	10,000	7,273	16,000	18,909	1,091	10,000
11	-	-	7,273	-	2,909	(2,909)	-
12	-	-	7,273	-	2,909	(2,909)	-
13	-	-	7,273	-	2,909	(2,909)	-
14	-	-	7,273	-	2,909	(2,909)	-
15	-	-	7,273	-	2,909	(2,909)	-
Total		$ 100,000	$ 109,091	$ 160,000	$ 203,636	$ (3,636)	$ 100,000

(1) End-of-year investment for a 5 percent limited partnership interest in the project net of amortization in column (2)

(2) Investment in excess of estimated residual value (zero in this case) amortized in proportion to tax credits received in the current year to total estimated tax credits.

(3) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.

(4) 8 percent tax credit on $200,000 tax basis of the underlying assets.

(5) Column (3) x 40% tax rate) + column (4).

(6) The change in deferred taxes resulting from the difference between the book and tax bases of the investment and tax losses in excess of the at-risk investment. In this example, that amount can be determined as follows: (column (2) - column (3)) x 40% tax rate.

(7) Column (5) + column (6) - column (2).

Schedule 3

Equity Method

Year	Net Investment (1)	Book Loss (2)	Tax Loss (Depreciation) (3)	Tax Credit (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
1	$ 92,727	$ 7,273	$ 7,273	$ 16,000	$ 18,909	$ -	$ 11,636
2	85,455	7,273	7,273	16,000	18,909	-	11,636
3	78,182	7,273	7,273	16,000	18,909	-	11,636
4	70,909	7,273	7,273	16,000	18,909	-	11,636
5	63,636	7,273	7,273	16,000	18,909	-	11,636
6	56,364	7,273	7,273	16,000	18,909	-	11,636
7	48,000	8,364	7,273	16,000	18,909	436	10,982
8	32,000	16,000	7,273	16,000	18,909	3,491	6,400
9	16,000	16,000	7,273	16,000	18,909	3,491	6,400
10	-	16,000	7,273	16,000	18,909	3,491	6,400
11	-	-	7,273	-	2,909	(2,909)	0
12	-	-	7,273	-	2,909	(2,909)	0
13	-	-	7,273	-	2,909	(2,909)	0
14	-	-	7,273	-	2,909	(2,909)	0
15	-	-	7,273	-	2,909	(2,909)	0
Total		$ 100,000	$ 109,091	$ 160,000	$ 203,636	$ (3,636)	$ 100,000

(1) End-of-year investment for a 5 percent limited partnership interest in the project less the investor's share of losses.

(2) The investor's share of book losses recognized under the equity method. The cumulative losses recognized are limited to the investment of $100,000. (See also * below.)

(3) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.

(4) 8 percent tax credit on $200,000 tax basis of the underlying assets.

(5) (Column (3) x 40% tax rate) + column (4).

(6) The change in deferred taxes resulting from the difference between the book and tax bases of the investment and tax losses in excess of the at-risk investment. In this example, that amount can be determined as follows: (column (2) - column (3)) x 40% tax rate.

(7) Column (5) + column (6) - column (2)

Projections of future operating results at the end of year 9 indicate that a net loss will be recognized over the remaining term of the investment indicating a need to assess the investment for impairment. For purposes of this example, impairment is measured based on the remaining tax credits allocable to the investor, although an alternative measure could include other tax benefits to be generated by the investment. The impairment loss recognized in this example ($18,543) is derived as follows: Investment at the end of year 8 ($41,816) less the loss recognized in year 9 ($7,273), the remaining tax credits allocable to the investor ($16,000), and the estimated residual value ($0).

The Task Force recognized that this is but one method for recognition and measurement of impairment of an investment accounted for by the equity method. The Task Force did not discuss all of the methods; inclusion of this method in this example does not indicate that it is a preferred method.

Schedule 4

Effective Yield Method

Year	Net Investment (1)	Tax Credit (2)	Amortization of Investment (3)	Tax Depreciation (4)	Current Tax Benefit (5)	Deferred Tax Benefit (Expense) (6)	Impact on Net Income (7)
1	$ 93,606	$ 16,000	$ 6,394	$ 7,273	$ 12,515	$ (351)	$ 12,164
2	86,598	16,000	7,008	7,273	11,901	(106)	11,795
3	78,916	16,000	7,682	7,273	11,228	164	11,391
4	70,496	16,000	8,419	7,273	10,490	459	10,948
5	61,268	16,000	9,228	7,273	9,681	782	10,463
6	51,154	16,000	10,115	7,273	8,794	1,137	9,931
7	40,067	16,000	11,086	7,273	7,823	1,525	9,348
8	27,916	16,000	12,151	7,273	6,758	1,951	8,709
9	14,598	16,000	13,318	7,273	5,591	2,418	8,009
10	-	16,000	14,598	7,273	4,311	2,930	7,241
11	-	-	-	7,273	2,909	(2,909)	-
12	-	-	-	7,273	2,909	(2,909)	-
13	-	-	-	7,273	2,909	(2,909)	-
14	-	-	-	7,273	2,909	(2,909)	-
15	-	-	-	7,273	2,909	(2,909)	-
Total		$ 160,000	$ 100,000	$ 109,091	$ 103,636	$ (3,636)	$ 100,000
Internal rate of return based on tax credits only						9.61%	

(1) End-of-year investment for a 5 percent limited partnership interest in the project net of amortization in column (3).

(2) 8 percent tax credit on $200,000 tax basis of the underlying assets.

(3) Column (2) - (beginning investment x 9.61%).

(4) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.

(5) Column (2) - column (3) + (column (4) x 40% tax rate).

(6) The change in deferred taxes resulting from the difference between the book and tax bases of the investment and tax losses in excess of the at-risk investment. In this example, that amount can be determined as follows: Column (3) - column (4)) x 40% tax rate.

(7) Column (5) + column (6).

Schedule 5

Fair Value Method

Year	Future Credits (1)	Net Investment (2)	Amortization of Investment (3)	Tax Depreciation (4)	Tax Credit (5)	Current Tax Benefit (6)	Deferred Tax Benefit (Expense) (7)	Impact on Net Income (8)
1	$ 144,000	$ 90,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
2	$ 128,000	$ 80,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
3	$ 112,000	$ 70,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
4	$ 96,000	$ 60,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
5	$ 80,000	$ 50,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
6	$ 64,000	$ 40,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
7	$ 48,000	$ 30,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
8	$ 32,000	$ 20,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
9	$ 16,000	$ 10,000	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
10	$ -	$ -	$ 10,000	$ 7,273	$ 16,000	$ 18,909	$ 1,091	$ 10,000
11	$ -	$ -	$ -	$ 7,273	$ -	$ 2,909	$ (2,909)	$ -
12	$ -	$ -	$ -	$ 7,273	$ -	$ 2,909	$ (2,909)	$ -
13	$ -	$ -	$ -	$ 7,273	$ -	$ 2,909	$ (2,909)	$ -
14	$ -	$ -	$ -	$ 7,273	$ -	$ 2,909	$ (2,909)	$ -
15	$ -	$ -	$ -	$ 7,273	$ -	$ 2,909	$ (2,909)	$ -
Total			$ 100,000	$ 109,091	$ 160,000	$ 203,636	$ (3,636)	$ 100,000

The fair value of the remaining tax credits is assumed to be $0.625 per $1 of tax credits.

(1) Future remaining tax credits as of end of year.

(2) End-of-year investment for a 5 percent limited partnership interest in the project net of amortization in column (3).

(3) Investment in excess of estimated residual value (zero in this case) amortized in proportion to fair value of future remaining tax credits [beginning investment value - column (1) x $0.625].

(4) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years.

(5) 8 percent tax credit on $200,000 tax basis of the underlying assets.

(6) Column (4) x 40% tax rate) + column (5).

(7) The change in deferred taxes resulting from the difference between the book and tax bases of the investment and tax losses in excess of the at-risk investment. In this example, that amount can be determined as follows: (column (3) - column (4)) x 40% tax rate.

(8) Column (5) + column (6) - column (2).