FASB Emerging Issues Task Force

Issue No. 13-B

Title: Accounting for Investments in Affordable Housing Tax Credits

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Background

1. The Low Income Housing Tax Credit (LIHTC or affordable housing tax credit) is a program designed to encourage investment in the construction and rehabilitation of low income housing. The program is an indirect tax subsidy that allows investors in a limited partnership that manages or invests in a qualified affordable housing project to receive the benefits of the tax credits allocated to the entity that owns the qualified affordable housing project. The LIHTC program was enacted under Section 42 of the Internal Revenue Code (IRC) in 1986 and made permanent by the Revenue Reconciliation Act of 1993. In 2010, the President's Economic Recovery Advisory Board (PERAB) estimated that the LIHTC program would cost the Federal Government $61 billion in lost tax revenue from participating corporations from 2008-2017.[1]

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* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

[1] President's Economic Recovery Advisory Board."The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation", The White House, Washington, D.C., 28 August 2010.

2. Investment in a qualified affordable housing project through a limited partnership investment (LIHTC investment) has different risks and rewards than a traditional equity investment. Generally, the investor in a LIHTC investment derives less return from the underlying operating cash flows and appreciation than an equity investor in more traditional investments. Investors in a LIHTC investment seek a majority of their return through the receipt of tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the LIHTC investment). Accordingly, a principal risk associated with LIHTC investments is potential noncompliance with the tax code requirements resulting in unavailability or recapture[2] of the tax credits (for example, failure to rent the affordable housing project to qualified tenants, ceasing to qualify as an affordable housing project, or foreclosure of the qualified affordable housing project may result in loss of tax credits).

3. A LIHTC investment can be made either through an equity investment as a limited partner of the operating entity that owns an individual qualified affordable housing project or through an investment in a limited partnership that invests in multiple operating entities that own qualified affordable housing project. In a typical LIHTC investment, the tax credits are allowable on the investor's tax return each year over a 10-year period as a result of renting a sufficient number of units to qualifying tenants. However, those credits are subject to recapture over a 15-year period starting with the first year tax credits are earned.

4. Under EITF Issue No. 94-1, "Accounting for Tax Benefits Resulting from Investments in Affordable Housing Projects" (codified in Subtopic 323-740, Investments—Equity Method and Joint Ventures—Income Taxes), a reporting entity that invests in a LIHTC investment may elect to account for that investment using the effective yield method if all of the following conditions are met:

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

[2] The taxpayer is required to repay earlier tax savings by payment of additional tax in the current taxable year.

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

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.

5. Under the effective yield method of accounting for LIHTC investments, the tax credit allocated to the investor, net of the amortization of the investment in the limited partnership (net benefits), is recognized in the income statement as a component of income taxes attributable to continuing operations. That is, in general, there are no pre-tax losses recognized in the financial statements for investments that qualify for the effective yield method.

6. For those LIHTC investments that are not accounted for using the effective yield method, paragraph 323-740-25-2 requires that those investments be accounted for in accordance with Subtopic 970-323, Real Estate—General—Investments—Equity Method and Joint Ventures, which results in LIHTC investments being accounted for under either the equity method or the cost method. Paragraphs 970-323-25-6 and 25-7 state the following:

> The equity method of accounting for investments in general partnerships is generally appropriate for accounting by limited partners for their investments in limited partnerships. A limited partner's interest may be so minor that the limited partner may have virtually no influence over partnership operating and financial policies. Such a limited partner is, in substance, in the same position with respect to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate.
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> Under the cost method, income recognized by the investor is limited to distributions received, except that distributions that exceed the investor's share of earnings after the date of the investment are applied to reduce the carrying value of the investment.

7. Additionally, paragraph 323-30-S99-1 states the following:

> The SEC staff's position on the application of the equity method to investments in limited partnerships is that investments in all limited partnerships should be accounted for pursuant to paragraph 970-323-25-6. That guidance requires the use of the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies." The SEC staff understands that practice generally has viewed investments of more than 3 to 5 percent to be more than minor.

8. When discussing Issue 94-1, the Task Force discussed whether LIHTC investments had characteristics of either receivables or investments in real estate and the application of both the equity method and cost method of accounting. The Task Force concluded that LIHTC investments that have a positive yield based solely on tax credits and a third-party guarantee are different from investments in real estate and allowed such investments to be accounted for using the effective yield method.

9. The equity method of accounting for LIHTC investments requires separate reporting of the investment performance and the tax credits, whereby the investment performance is reported within pre-tax income and the tax credits within after-tax (net) income. The investment performance is typically a loss because qualified affordable housing projects mainly operate at break-even from a cash flow perspective and the limited partnership records depreciation expense on the affordable housing project and interest expense from other project financing. Therefore, because the tax credits are presented separately from the investment performance, the after tax net benefit from the investment performing as intended is not evident in a single line item of the financial statements of the investor. The cost method of accounting results in a similar (gross up) presentation in the income statement.

10. Some believe that the resulting presentation in the income statement of the pre-tax investment performance separately from the tax benefits distorts investment performance by reporting pre-tax losses on otherwise profitable investments, and makes investment performance difficult to understand. In addition, some constituents also believe that certain conditions that must be met to account for LIHTC investments using the effective yield method are restrictive and should be reconsidered. Specifically:

a. *Guarantee by a creditworthy entity:* Less than 5 percent of the LIHTC investments currently qualify for the effective yield method under Issue 94-1 because of this requirement.[3] While no specific guidance is provided 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. The rationale behind the creditworthy guarantor requirement is based on the uncertainty related to the availability of the tax credits, and absent the tax credits there is no reason to include the operating results of the investment on the income tax line in the financial statements. However, since the inception of the LIHTC program, it has been demonstrated that the receipt of tax benefits by investors is probable.

b. *Positive yield based solely on the cash flows from the guaranteed tax credits:* Reporting entities that invest in LIHTC investments generally view yield as a combination of all cash inflows from the investment, including tax credits and other tax benefits (such as tax losses reported by the limited partnership that flow up to the investor). Yields based solely on tax credits generally have declined since the credit's inception as a result of the lower risk profile of these investments, and, accordingly, the requirement for a positive yield based solely on cash flows from the guaranteed tax credits is difficult to meet.

Scope

11. This Issue applies only to limited partnership investments in affordable housing projects. In reaching the decision to add this Issue to the Task Force's agenda, the Board noted that limiting the scope of this Issue will allow the Task Force to expeditiously address the issue and the various concerns in practice with respect to the income statement presentation of those investments. Because there is existing guidance in Issue 94-1, the Task Force would have the ability to revisit the conclusions of that consensus to determine whether modifications are necessary to the criteria for applying the effective yield method to investments in affordable housing projects.

[3] Source: "Significant Changes Needed in Accounting for Affordable Housing and Other Tax Credit Investments," Michael Beck and Bentley Stanton, June 22, 2012.

12. Additionally, due to the potential interaction with the FASB's pre-agenda research project on the accounting for government assistance, and the complexities involved in defining a "tax credit investment," the Board believes that the scope of this Issue should be narrow.

Accounting Issue and Alternatives

How an entity should account for its limited partnership investment in a qualified affordable housing project.

View A: An entity may elect to account for a LIHTC investment using the effective yield method if certain (revised) conditions are met. If the LIHTC investment does not qualify for the effective yield method, the investment shall be accounted for as an equity or cost method investment in accordance with Subtopic 970-323.

13. Under View A, an entity can elect to use the effective yield method of accounting if it meets all of the following conditions:

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

b. The investor retains no operational influence over the investment, and substantially all of the projected benefits are from tax credits and other tax benefits.

c. The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment) is positive.

d. 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.

14. For those LIHTC investments not accounted for using the effective yield method, the investment shall be accounted for in accordance with Subtopic 970-323, consistent with current guidance. Subtopic 970-323 requires the use of the equity method of accounting for limited partnership investments unless the limited partner's interest is so minor that it gives the partner

virtually no influence over partnership operating and financial policies, in which case, accounting for the investment using the cost method may be appropriate.

15. Proponents of View A believe that the risk level of LIHTC investments has decreased considerably since the EITF originally deliberated the Issue. The receipt of tax benefits by investors has been demonstrated to be probable, which is also evidenced by the lower yields. Consequently, certain criteria included in Issue 94-1 are no longer relevant and should be revised.

16. Proponents of View A further state that investments in a limited partnership for tax credits are different from investments in an operating entity that owns real estate. Investors who make limited partnership investments in an operating entity that owns real estate do so primarily to earn income from the real estate owned by the operating entity. That income is provided by the cash flows generated from operations and from appreciation of the real estate held by the operating entity. Although investors in limited partnerships for tax credits are legally required to participate in the risks and rewards of ownership in order to receive the tax credits, they generally do not rely on the cash flows of the underlying assets, such as real estate, or their eventual disposition for their investment return, rather, they consider their investment return to be primarily the receipt of tax credits and other tax benefits. The operating losses generated by the LIHTC investment should be considered as part of the net investment in tax credits and not as operating losses that should be presented separately in the pretax income of the investor. Therefore, proponents of View A believe that LIHTC investments should not be accounted for using the equity method of accounting in accordance with Subtopic 970-323.

17. Opponents of View A state that limited partnership interests in an entity that holds real estate and operates that real estate should be treated in most cases as an equity investment regardless of the nature of the investor returns. Therefore, the qualifying threshold for the effective yield method should remain high, such that only those investors with virtually no risk of economic loss qualify for the effective yield treatment. These opponents believe that a guarantee by a creditworthy entity would in most cases be necessary for reducing the risk of economic loss to an acceptably low level. Further, these opponents believe that operating losses

generated by LIHTC investments should not be presented in the income tax line item of a reporting entity's financial statements.

18. Opponents of View A also are concerned that if the criteria to apply effective yield method are modified to be less restrictive, it would become difficult to separate LIHTC investments from other investments that generate significant tax benefits.

View B: Reaffirm the consensus reached in Issue 94-1 for LIHTC investments.

19. Under View B, an entity can elect to use the effective yield method of accounting if all of the following criteria, consistent with current guidance, are met:

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

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

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.

20. For a limited partnership investment in a qualified affordable housing project not accounted for using the effective yield method, the investment shall be accounted for in accordance with Subtopic 970-323.

21. When Issue 94-1 was originally presented at the January 24, 1994 EITF meeting, the proponents of the effective yield method believed that investors in affordable housing projects were in substance acquiring the right to receive tax benefits and all other aspects of the investment were considered insignificant, as evidenced by the manner in which these investments are structured and marketed. Elements of certain partnership agreements that suggest that the transaction is analogous to the purchase of tax benefits, include:

a. Limiting the partner's return on its investment by having excess cash flows distributed to the general partner,

b. Limiting the profit on subsequent sale of the project

c. Guarantees by the general partner providing a "targeted" rate of return on the project.

22. With provisions such as those above, the proponents of using the effective yield method believed that the investor should record its share of the benefits as earned and amortize the cost of the investment over the life of the project to provide an effective yield, taking into consideration the tax credits received, investment cost, and the estimated residual value in the project. Based upon the substance and economics of how the investment is priced, these proponents argued that it is appropriate to look beyond the legal form of the limited partnership investment.

23. Opponents of using the effective yield method believed that a limited partner in an affordable housing project shares in the risks and rewards of ownership. There is uncertainty related to the tax benefits to be received because of (a) the level of operating profits and (b) the requirement that the project maintain certain levels of qualifying rents during the first 15 years of operation. The limited partner may also share in an amount of partnership taxable income or loss over the life of the project. These opponents argued that the characteristics of an investment in an affordable housing project are similar to the risks and rewards of ownership of a typical limited partnership investment. Further, these opponents noted that although the unique characteristics of investments in these projects, as noted above, could be indicative of a preferred interest or some other form of investment, the characteristics are not compelling enough to overcome the fact that the investor has ownership in a limited partnership.

24. Currently, proponents of View B believe that the qualifying threshold for the effective yield method should remain high, such that only those investors with virtually no risk of economic loss qualify for the treatment. They believe that a guarantee by a creditworthy entity would in most cases be necessary for reducing the risk of economic loss to an acceptably low level. Further, the

exception to apply the effective yield method that results in the inclusion of operating expenses in the tax line item of an entity's financial statements should be limited to only those entities that receive benefits primarily from the tax credits associated with the LIHTC property.

25. Proponents of View B also believe that the requirement for positive yield based solely on the cash flows from the tax credits is necessary to ensure that the primary purpose of the investment is to receive the tax credits associated with the affordable housing property. These proponents are concerned that if the criteria to apply the effective yield method are modified to be less restrictive, it would become difficult to separate LIHTC investments from other investments that generate significant tax benefits, for example, as a result of accumulated net operating losses.

View C: An entity shall account for all LIHTC investments in accordance with Subtopic 970-323; therefore, the guidance in Issue 94-1 (codified in Subtopic 323-740) should be removed from U.S. GAAP.

26. Proponents of View C believe that the characteristics of LIHTC investments are similar to the risks and rewards of ownership of a typical limited partnership investment as noted earlier. Additionally, proponents of this view believe that since the existing guidance in Issue 94-1 is not applicable to the majority of LIHTC investments, this guidance creates unnecessary diversity in practice for a small number of entities.

27. Proponents of View C also believe that there should not be an exception to the requirement to separately account for the investment and its tax effects. These proponents note that the Board recently affirmed its decision to eliminate the separate lease accounting model for leveraged leases, which is an accounting model that factors tax benefits into a calculated after tax yield. Removing the exception that permits the effective yield method of accounting for certain investments in affordable housing tax credits would be consistent with the Board's decision in the leases project.

Recurring Disclosures

28. As stated in Issue 94-1, the Task Force observed that if the conditions are met, the election to apply the effective yield method would be a policy decision rather than a decision to be applied to individual investments that qualify for the use of the effective yield method. Therefore, reporting entities would be required to comply with the accounting policy disclosure requirements in Topic 235, Notes to Financial Statements.

29. Additionally, Issue 94-1 did not require any recurring disclosures for LIHTC investments. Therefore, to help financial statement users understand the terms of LIHTC investments and their impact on the financial statements, if either View A or View B is selected the FASB staff believes that the following recurring disclosures should be required:

a. The method of accounting for LIHTC investments

b. For investments not accounted for under effective yield method, the amount of gain or loss included in the entity's income from operations before tax and the amount of tax credits and other tax benefits recognized during the reporting period

c. For investments accounted for under effective yield method, the impact on net income recognized and tax benefits other than investment tax credits recognized

d. The number of remaining years of unexpired tax credits and the required holding period for the LIHTC investments

e. Whether the LIHTC property is currently subject to any regulatory reviews and the status of such reviews (for example, investigations by the housing authority)

f. Any commitments or contingent commitments (for example, guarantees or commitments to provide additional capital contributions), including the amount of equity contributions that are contingent commitments related to LIHTC investments and the year(s) that contingent commitments are expected to be paid

g. If LIHTC investments are significant to the reporting entity's financial position and results of operations:

- Summarized information about assets, liabilities, and results of operations for limited liability companies either individually or in groups

- The tax benefits expected to be received over the life of each significant LIHTC investment

h. The amount and nature of the write-downs during the year resulting from the forfeiture or ineligibility of tax credits, or other circumstances. These write-downs may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions within an LIHTC investment, or other issues.

Transition

30. If the Task Force reaches a consensus on View A, following are two transition alternatives for consideration:

View A: Entities should apply this Issue on a retrospective basis by applying the requirements for accounting changes in paragraphs 250-10-45-5 through 45-10. Early adoption is permitted.

31. Proponents of View A observe that the FASB's Conceptual Framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. Those proponents refer to paragraph B7 of the Basis for Conclusions in FASB Statement No. 154, *Accounting Changes and Error Corrections*, which states that:

> The Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data.

View B: Entities should apply this Issue on a prospective basis to new LIHTC investments entered into after the date of adoption. Entities would be permitted to apply this Issue retrospectively by applying the requirements for accounting changes in paragraphs 250-10-45-5 through 45-10. Early adoption is permitted.

32. Proponents of View B believe that the requirements of this view would generally be less costly and less burdensome than applying the Issue on a retrospective basis because an entity would not need to restate the accounting for existing investments in affordable housing tax credits.

33. Opponents of View B observe that if the alternative in View A was selected, post-adoption-date LIHTC investments that qualify for use of the effective yield method would not be accounted for on the same basis as pre-adoption-date LIHTC investments that meet the amended requirements. This would adversely affect financial statement comparability because of the long duration of LIHTC investments. Additionally, this would be contrary to the observation in Issue 94-1 that the decision to apply the effective yield method should not be made individually to investments that qualify for use of the effective yield method.

View C: Entities should apply this Issue on a prospective basis to all LIHTC investments existing at the beginning of the fiscal year of adoption by recording the cumulative effect of the change to opening retained earnings at the beginning of the fiscal year of adoption. Entities would be permitted to apply this Issue retrospectively by applying the requirements for accounting changes in paragraphs 250-10-45-5 through 45-10. Early adoption is permitted.

34. Proponents of View C observe that the requirements of this view would generally be less costly and less burdensome than applying the Issue on a retrospective basis but would result in consistent accounting for all LIHTC investments in future periods. Additionally, this would be consistent with the observation in Issue 94-1 that the decision to apply the effective yield method should not be made individually to investments that qualify for use of the effective yield method.

35. The FASB staff recommends transition View A. The staff believes that even though there may be more costs in applying the Issue retrospectively, View A improves the comparability of financial statements and will provide financial statement users with more information regarding the net benefit of investing in affordable housing tax credits.

Transition Disclosures

36. The guidance on other presentation matters in Subtopic 250-10, Accounting Changes and Error Corrections—Overall, is applicable for any voluntary change in accounting principle, including a change in the method of applying an accounting principle. The staff recommends that if View A is selected, the Task Force should require companies to apply the disclosure requirements in Section 250-10-50 for an accounting change required by this Issue. Additionally, the staff recommends that the Task Force not require any additional transition disclosures other than the requirements in paragraphs 250-10-50-1 through 50-3.