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Financial Accounting Standards Board  
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File Reference: No. EITF-13B, Investments – Equity Method and Joint Ventures (Topic 323), Accounting for Investments in Qualified Affordable Housing Projects

Dear FASB Board Members and Staff:

The PNC Financial Services Group, Inc. ("PNC" or "we") appreciates the opportunity to comment on the Proposed Accounting Standards Update, Investments – Equity Method and Joint Ventures (Topic 323), Accounting for Investments in Qualified Affordable Housing Projects (the "Proposed ASU") which solicits feedback on the Financial Accounting Standards Board’s ("FASB's") proposal on accounting for investments in affordable housing projects that qualify for low income housing tax credits ("LIHTC investments").

Summary

Investments in qualified affordable housing projects have different risks and rewards than traditional equity investments since a majority of the return on the investment is through receipt of tax credits and other tax benefits (i.e., expenses that reduce taxable income). We believe the current application of equity method accounting to these investments, under which flow-through equity method expenses and investment amortization are presented in pre-tax expenses, while the tax benefits are included in income tax provision/benefit, makes it difficult for users of our financial statements to understand the purpose and benefits of the LIHTC investment. Therefore, we are very supportive of the FASB's proposal to address the current income statement geography issue by allowing equity method expenses and investment amortization to be recorded in income tax provision/benefit. We believe this proposed presentation accurately represents the economics and substance of these tax benefit driven transactions.

Income Statement Geography

Income statement geography is our most significant concern with respect to accounting for tax credits and other tax benefits from LIHTC investments. Operating entities for affordable housing projects are
designed to operate at or near breakeven from a cash flow perspective. Since non-cash depreciation charges on the property are recognized, most affordable housing tax credit property entities report net losses in their financial statements. Under existing GAAP, flow-through equity method expenses and investment amortization are generally presented in pre-tax expenses, separate from the tax benefits, which are included in income tax provision/benefit. As a result, pre-tax losses are reported when the investment is performing as intended and yielding an after-tax net benefit to the investor. We believe presentation of pre-tax earnings/losses is most appropriate for investments made for the purpose of operating real estate to generate income and/or to profit from appreciation of the property. Conversely, separation of the pre-tax losses from the recognition of tax benefits is not consistent with the objective of profiting primarily from the realization of tax benefits.

We support the presentation of tax credits and other tax benefits, net of amortization of the investment, in income tax provision/benefit when the objective of the investment is primarily to profit from the realization of tax benefits. We believe expanding the use of the effective yield method (or the alternative method discussed below) by eliminating the requirement that the availability of the tax credits must be guaranteed will provide the appropriate income statement presentation for these investments. PNC expects that eliminating this requirement and making the other modifications set forth in the Proposed ASU, will improve financial reporting for investments in qualified affordable housing projects while distinguishing them from direct investments in real estate.

Scope

PNC generally agrees that an investment in qualified affordable housing should satisfy the conditions set forth in proposed paragraph 323-740-25-1 in order to apply the effective yield method (or the alternative method noted below). However, we recommend the Emerging Issues Task Force ("EITF") consider modifying the "no operational influence" language in sub-paragraph (aa) to "no significant operational influence over the underlying real estate property." We believe this change would address the following concerns:

- Investors commonly have limited rights which could be interpreted to be more than protective in nature and thus preclude the application of this proposed guidance even though the influence may be inconsequential to the substance of the investment. For example, limited partners ("LPs") who invest in affordable housing projects may have the ability to, upon a simple majority vote of all LPs, remove the general partner ("GP") without cause. Such limited rights do not change the purpose of the investment and thus, should not dictate the accounting treatment.

- Based on paragraph 323-740-15-3 in the Proposed ASU, our interpretation is that investments in both operating partnerships ("Lower-Tier"), which own and operate the properties generating the tax benefits, and fund partnerships ("Upper-Tier"), which invest in multiple Lower-Tier partnerships, would be within the intended scope of this guidance. Further, we believe the EITF intended the phrase "no operational influence over the investment" in paragraph 323-740-25-1(aa) to refer to influence over the day-to-day management of the real property which generates the tax benefits. However, because the Proposed ASU does not explicitly state what "the investment" is, the guidance should be clarified. As a syndicator of low-income housing tax credit investments, PNC often holds a GP interest as well as a modest LP interest in Upper-Tier partnerships and is concerned that "the investment" could be interpreted to mean the Upper-Tier partnership. If the Proposed ASU is interpreted that way, GPs of these entities would likely be precluded from applying this guidance. However, most Upper-Tier partnerships invest solely
in LP interests of Lower-Tier partnerships. Both GP interests in Upper-Tier partnerships and LP interests in Lower-Tier partnerships are passive with regards to management of the underlying property and neither have the characteristics of a typical direct investment in real estate. Therefore, we believe this Proposed ASU should apply equally to Upper-Tier investors (including both GPs and LPs) and Lower-Tier LP investors, and that regardless of whether the Upper-Tier partnership is consolidated\(^1\), all tax benefits (i.e. credits, depreciation, interest expense, etc.) should be recognized in the tax provision line.

While other types of investments such as investments in new markets, historic, and renewable energy tax credits are similar to LIHTC investments in that the substance is an investment in tax credits, each of these tax credit structures has unique features. LIHTC investments have existed since the mid-1980s and are well understood, have investment structures that are generally uniform across the industry, and have a proven track record of generating the anticipated tax benefits. Given these factors, we encourage the EITF to conclude deliberations on this Proposed ASU as expeditiously as possible. However, we acknowledge that other types of tax credit investments deserve consideration at a later date, and based on their substance, should be accounted for consistent with LIHTC investments.

**Effective Yield Method/Ratable Amortization Method**

As previously noted, PNC strongly supports a standard that allows all tax benefits (i.e. credits, depreciation, interest expense, etc.) to be recognized in the tax provision line. We support this Proposed ASU so long as that objective is achieved as we consider income statement geography to be the most important issue.

We believe there is more than one reasonable method to account for the recognition of all tax benefits relating to these investments, including the effective yield method, which represent an improvement to equity method accounting. PNC prefers a method that aligns income statement recognition with the receipt of tax benefits compared to the effective yield method. We believe a method whereby investment amortization is recorded in proportion to the tax credits received, and netted within the tax line together with the tax credits and other tax benefits that are recognized as they are received ("ratable amortization method"\(^2\)), appropriately reflects the economics of the transactions and has the added benefit of reducing administrative burden. For the following reasons, we believe the ratable amortization method, where the aggregate tax provision/benefit impact and net income impact are calculated consistent with the cost method reflected in the example provided in paragraph 323-740-55-6, may be preferable to the effective yield method:

- The effective yield method, as reflected in the example in paragraph 323-740-55-10, is an appropriate income recognition methodology for debt instruments that have a principal amount, require interest payments on the outstanding balance, and for which cash flows are contractually defined. Since the nature of debt instruments is generally to pay a constant rate of interest on the invested amount\(^2\), this treatment is appropriate. However, investments in

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\(^1\) For consolidated LIHTC investments, the operating losses of the consolidated partnership are reflected in pre-tax expenses of the consolidating entity and offset through net income (loss) attributable to noncontrolling interests. Third party tax credits are not reflected upon consolidation. An improved presentation of the consolidated investment would be achieved by including all operating expenses of the consolidated partnership, along with the consolidating entity’s own tax credits, in the income tax provision line.

\(^2\) Consider the example of a loan purchased at par that has a fixed interest rate and a principal balance that amortizes over a defined period of time. The stated interest rate is the investor’s constant yield. It is therefore logical that income on this loan, if purchased at a premium or discount, should be recognized based on its constant effective yield.
affordable housing projects have certain characteristics which differentiate them from debt instruments such that we believe a method other than the effective yield method may be more appropriate. These characteristics include:

- There is uncertainty with regard to the term of the investment – tax credits are generally received over a period of about 10 years and other tax benefits can be received over a longer period;

- There may be variability in the amount of tax benefits to be received each period – operating losses may vary from period to period based on the operational performance of the underlying property or properties, causing uneven realization of tax benefits over the investment period;

- The tax credits are subject to compliance risk (risk that the general partner of the Lower-Tier Partnership does not ensure the property satisfies the requirements to receive tax credits) and risk that the reporting entity will not have sufficient taxable income to make use of the credits received. Both enhance the likelihood of variability in the timing of tax benefit realization.

Together, these factors suggest that a constant yield may not be realized over the life of the investment and that actual cash flows can differ from initial projections. Therefore, we believe that a method other than the effective yield method would be more appropriate for these investments.

- The effective yield method results in more income and less amortization recognized in early periods than in later periods. Accelerating income recognition does not reflect how the income tax benefits are generally realized (i.e., tax credits are generally realized ratably over the first 10 years of the investment\(^3\) and other tax benefits can be realized over a longer period).

- A byproduct of the effective yield method is that impairment of the investment balance will be required in or around year ten when the investment is performing as expected. The example in paragraph 323-740-55-10 in the Proposed ASU shows impairment taken when "the investment will generate a negative yield over the remaining term of the investment." We do not believe that a performing asset should be impaired when there has been no identifiable deterioration in value other than tax credits being received and used by the reporting entity. Alternatively, a ratable amortization method would ensure that the investment balance is adjusted to zero by the end of year 10 thus eliminating the need to impair the performing asset. Furthermore, paragraph 323-740-35-2 in the Proposed ASU states that:

> "Under the effective yield method, the investor recognizes tax credits and other tax benefits as they are realized and amortizes the initial cost of the investment to provide a constant effective yield over the period that tax credits and other tax benefits are allocated to the investor [emphasis added]."

\(^3\) It is often the case that investments in Upper-Tier partnerships will yield tax credits over a period slightly longer than 10 years due to the underlying investments of the partnership initially being made over a period of several years. These timing differences cause a ramp-up and ramp-down in the realization of tax credits such that they are not always received on a 100% ratable basis.
However, as noted above, the effective yield method results in impairment in or around year ten. As such, the initial cost of the investment would not be amortized on a constant effective yield basis over the period required by paragraph 323-740-35-2.

Although we believe the ratable amortization method is preferable to the effective yield method, we still believe the effective yield method represents an improvement in the accounting for LIHTC investments over equity method accounting because it allows for recognition of all tax benefits in the tax provision/benefit line. Therefore, we would support the finalization of a standard which retains the effective yield method. If the EITF retains the effective yield method, we suggest that a more robust set of examples be added to the implementation guidance in the finalized standard. The EITF should consider providing examples that address, at a minimum, the following scenarios:

- Flow-through income/loss is not zero,
- An entity's expectation of future tax benefits changes. We understand that other institutions which currently apply the effective yield method hold the effective yield constant. The example should clarify whether the effective yield would be held constant or should be adjusted to reflect the new projections and if so, how that adjustment would be effected (e.g., prospectively), and
- The intended amortization period (given the wording in proposed paragraph 323-740-35-2, it appears that the initial cost must be recognized over the 15-year investment period instead of the 10-year period as indicated by proposed paragraph 323-740-55-6i).

Disclosure

We support the principles-based approach to the disclosure requirements, including examples of disclosures that could be considered in order to meet the primary disclosure objectives. However, we believe that if the suggestion to disclose whether the qualified affordable housing project is currently subject to any regulatory reviews and the status of such reviews were to become a requirement, it requires clarification. These projects are subject to routine regulatory reviews to ensure compliance with tax credit program requirements and often result in immaterial findings that are addressed within a “cure” period before the tax credits are disallowed or recaptured. In order to provide meaningful, not overly voluminous information, the requirement to disclose whether a project is currently subject to any regulatory reviews should only pertain to those regulatory reviews which are expected to have a material impact on the investor’s financial statements.

Transition

Whether the effective yield method or ratable amortization method are appropriate under the finalized standard, we suggest a modified retrospective approach with a cumulative-effect adjustment to an entity’s opening retained earnings at the beginning of its fiscal year of adoption. We believe the efforts required to recast prior year financial statements would be onerous and would outweigh the benefit of comparability. We also support the EITF’s intention to allow early adoption as we believe investors will benefit from earlier application of this guidance.
We appreciate the Board's request for feedback on this matter and appreciate the opportunity to share our views with the Board and staff. We welcome any questions or comments you may have. Please contact me with any questions about PNC's comments at 412-762-7546.

Sincerely,

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