FASB Emerging Issues Task Force

Issue No. 13-B

Title: Accounting for Investments in Qualified Affordable Housing Projects

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FASB Staff: Brown (203.956.3471) / Klumpp (203.956.5388)

EITF Liaison: Jackson Day

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Background

1. At the September 13, 2013 EITF meeting, the Task Force reached a tentative decision to revise the condition in amended paragraph 323-740-25-1(aa) of the proposed Update as follows (added text is underscored and deleted text is ~~struck through~~):

> The investor does not have the ability to exercise ~~retains no operational~~ significant influence over the ~~LIHTC investment other than protective rights~~ operating and financial policies of the limited liability entity, and substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment).

2. In reaching that decision, the Task Force determined that the existence of significant influence should be assessed in accordance with Topic 323 considering the indicators of significant influence in paragraphs 323-10-15-6 and 15-7. The Task Force acknowledged that the guidance in those paragraphs was intended for application to investments in common stock and not to investments in limited liability partnership interests. Therefore, the subsequent paragraphs

* **The alternative views presented in this Issue Summary Supplement 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.**

(paragraphs 323-10-15-8 through 15-11) that address voting stock ownership levels (for example, the significant influence presumption at a 20 percent or more voting stock ownership) would not be applicable in the determination of whether a limited liability investor has significant influence in a LIHTC investment. However, if a reporting entity either does not qualify for or elects not to apply the guidance in the proposed Update, it should continue to apply the existing guidance for real estate investments in paragraph 970-323-25-6, as interpreted for SEC registrants in paragraph 323-30-S99-1, in evaluating whether the limited liability entity would be accounted for as an equity method or a cost method investment. That is, when an entity does not qualify for or elects not to apply the guidance in the proposed Update, the equity method should be used unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies."

3. The Task Force also decided that other transactions, such as bank loans, between the investor and the limited liability entity should not preclude an investor from applying the guidance in the proposed Update as long as the LIHTC investment is made for the primary purpose of receiving tax credits and other tax benefits. To reach that objective, the Task Force decided to introduce the following principle by amending Section 323-740-25:

> Other transactions between the reporting entity and the limited liability entity should not be considered in determining whether the conditions in paragraph 323-740-25-1 are met, provided that (a) the reporting entity is in the business of entering into those transactions, (b) the transactions are entered into at market rates commensurate to rates offered to other counterparties with similar credit quality, and (c) the transactions do not give the reporting entity the ability to exercise significant influence over the operating and financial policies of the limited liability entity.

4. The Task Force also tentatively decided that a reporting entity should evaluate its eligibility to continue to elect to use the guidance in the proposed Update (a) on the basis of facts and conditions that exist at the time of the initial investment or (b) upon a change in the nature of the investment or upon a change in the relationship with the limited liability entity that could result in the reporting entity no longer meeting the conditions in paragraph 323-740-25-1 in the proposed Update.

5. The Task Force decided to change the method of accounting from the effective yield method to the proportional amortization method on the basis that it would provide a reasonable reflection of the economics of such investments in a less complex manner. Under the proportional amortization method, the cost of the investment would be amortized each reporting period in proportion to the tax credits and other tax benefits received. The resulting amortization would be recognized as a component of income taxes attributable to continuing operations. The Task Force clarified that a reporting entity electing the proportional amortization method should not record deferred taxes on the book and tax basis differences in the investment because (a) the investment has similarities with the purchase of future tax benefits, as illustrated in paragraphs 740-10-55-199 through 55-201, and (b) it would not be appropriate to record deferred taxes on a temporary difference resulting from an amortization that is already being recorded within the income tax provision.

6. Additionally, to be consistent with its determination that these investments are tax credit investments that are economically different from other real estate entity investments, the Task Force tentatively decided that the LIHTC investment should be classified as a deferred tax asset on a reporting entity's balance sheet and not as an investment. The Task Force requested that the FASB staff perform additional analysis of its tentative decision to present the investment as a deferred tax asset on the balance sheet.

7. The Task Force also discussed whether the guidance in the proposed Update should be extended to tax credit investments other than LIHTC investments. Some Task Force members expressed a view that the proportional amortization method should be applied to all tax credit investments that meet the revised amended conditions because that method would be suitable for all tax credit investments that are made for the primary purpose of receiving tax credits and other tax benefits regardless of the type of investment. Those Task Force members favored extending the guidance to other tax credit investments or allowing the use of analogy to this guidance. Other Task Force members expressed concern that there may be unintended consequences if the guidance in the proposed Update were applied to other types of tax credit investments, primarily transactions between the investor and the limited liability entity that were not contemplated in the development of the proposed guidance (for example, an energy purchase agreement in a

renewable energy tax credit investment). The Task Force requested that the FASB staff perform further outreach and research to determine whether other types of tax credit investments would meet the revised amended conditions in the proposed Update. The Task Force also requested that the FASB staff analyze other transactions between an investor and a limited liability entity that may be common in other types of tax credit investments.

Outreach Summary and FASB Staff Analysis and Recommendations

8. The FASB staff performed outreach with a number of stakeholders including nine preparers; two accounting firms; one industry task force represented by users, preparers, and accountants; and one banking regulator to obtain feedback on one or more of the following topics:

a. Classification of the tax credit investment as a deferred tax asset on the balance sheet
b. Whether the guidance in the proposed Update should be expanded to include other types of tax credit investments, and whether other types of tax credit investments would meet the revised amended conditions in the proposed Update
c. Whether other transactions between an investor and a limited liability entity may be common in other types of tax credit investments.

9. In addition to the above topics, a majority of those stakeholders indicated that they were concerned about the Task Force's proposed incorporation of "other tax benefits" in determining the pattern of amortization under the proportional amortization method. The results of the outreach and the related FASB staff recommendations are presented below. The issue summary supplement also includes a discussion of other feedback received related to the proportional amortization method, and an analysis of whether a revised Exposure Draft is necessary based on the nature and scale of revised amendments in the proposed Update resulting from the Task Force's tentative decisions.

Deferred tax asset classification

10. All stakeholders disagreed with presenting the tax credit investment as a deferred tax asset on the balance sheet. Most stakeholders noted that the tax credit investment does not meet the definition of a deferred tax asset in Topic 740. Topic 740 requires that a reporting entity

recognize a deferred tax liability or asset for the estimated future tax effects attributable to temporary differences and carryforwards. Paragraph 740-10-05-7 defines a temporary difference as follows:

> A temporary difference refers to a difference between the tax basis of an asset or liability, determined based on recognition and measurement requirements for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Deferred tax assets and liabilities represent the future effects on income taxes that result from temporary differences and carryforwards that exist at the end of a period. Deferred tax assets and liabilities are measured using enacted tax rates and provisions of the enacted tax law and are not discounted to reflect the time-value of money.

11. Stakeholders stated that the tax credit investment is neither a difference between the tax basis of the investment and the reported amount in the financial statements, as defined above, nor analogous to a tax credit carryforward because the related tax credits are not earned and therefore are not available at the time of initial investment. The classification of an investment within deferred tax assets would therefore have the effect of aggregating assets of dissimilar nature on the balance sheet. Further, classifying the tax credit investment as a deferred tax asset would require a new category and definition of deferred tax assets in the Codification, and may drive users of financial statements to misinterpret the deferred tax balance as a temporary difference on the investment's tax and book basis, or as an available tax credit carryforward when the nature of LIHTC investments is neither.

12. Stakeholders brought up the following reasons why these tax credit investments are different from other deferred tax assets (including purchased future tax benefits as described in Example 6 of EITF Issue 98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations"), and therefore should not be classified as deferred tax assets:

a. The entity acquired in Example 6 of Issue 98-11 has nominal assets other than its net operating loss carryforwards, while the limited liability entity has the tax credit property that generates income, operating expenses, depreciation expense, and interest expense.

b. The reporting entity in Example 6 purchases an entity that has available net operating losses, while the tax credits are not available at the initial inception of a LIHTC project.
c. Deferred tax assets resulting from tax credit carryforwards are not marketable unless they are sold in connection with the sale of the reporting entity itself (or in connection with the sale of a consolidated entity). Therefore, the value of such a deferred tax asset is derived through the utilization of the tax credits when a reporting entity has taxes payable. In contrast, LIHTC investments can be monetized through sale of the investments to other parties that have taxes payable even if the holder does not.
d. Deferred tax assets are subject to unique accounting and reporting requirements under U.S. GAAP, which may not be appropriate financial reporting for LIHTC investments, including but not limited to (a) the netting requirements of deferred tax assets and liabilities, (b) the assessment of valuation allowance on the basis of the reporting entity's assessment of profitability as opposed to a more appropriate impairment method based on the economic performance of the investment itself, (c) the ability to reverse a valuation allowance for deferred tax assets when that ability does not exist for most other investment impairments.

13. Constituents also stated that the classification of the tax credit investment as a deferred tax asset would adversely affect the minimum regulatory capital requirements for reporting entities subject to U.S. and global banking industry regulations because deferred tax assets do not have the same risk weighting in those calculations as investments do. The banking regulator the FASB staff reached out to also confirmed that the Task Force's tentative decision to classify LIHTC investments as deferred tax assets would have the effect of increasing minimum capital requirements for banks in most cases. The banking regulator further noted that absent a prescribed change in the balance sheet presentation of such investments in U.S. GAAP, the regulator's current treatment of those investments in capital requirement calculations would remain unchanged.

14. Based on the feedback received, the FASB staff recommends that the guidance in the proposed Update not specify the balance sheet classification of tax credit investments within the scope of the proposed Update. The FASB staff believes that those investments do not have the

characteristics of deferred tax assets and agrees with the stakeholders that deferred tax asset classification could have significant and adverse consequences for both financial reporting and regulatory capital purposes. The FASB staff further notes that the issue brought to the Task Force was about changing the presentation of these investments in the income statement to better reflect their economic substance, and the Task Force has already addressed that issue based on its merits. The FASB staff does not believe that the Task Force needs to prescribe a balance sheet classification for the purpose of achieving symmetry with the income statement classification. The FASB staff believes that the presentation of those tax credit investments as investments is reasonable and appropriate but, because reporting entities often include such investments in other asset captions, the staff recommends not prescribing a specific balance sheet presentation.

Question 1 for the Task Force: Does the Task Force agree with the FASB staff recommendation to not provide guidance about the balance sheet classification of tax credit investments within the scope of the proposed Update?

Expanding the Scope to Include Other Tax Credit Investments

15. During the FASB staff outreach, most stakeholders stated that the revised amended conditions in the proposed Update provide a framework for principles-based application and are appropriate to apply to other types of tax credit investments. That feedback was consistent with the feedback received through the comment letters. If other current or future tax credit investments meet the conditions in the proposed Update, the FASB staff believes that they should qualify for the proportional amortization method because meeting those conditions would demonstrate that the purpose of the investment was primarily to receive tax credits and other tax benefits.

16. During the FASB staff outreach, many of the preparers stated that they also hold other types of tax credit investments, including New Markets, Renewable Energy, and Historic tax credit investments; however those investments are typically a smaller part of their investment portfolios than LIHTC investments. Those preparers and two accounting firms indicated that fewer of those other types of tax credit investments would likely meet the conditions in the proposed Update (compared to LIHTC) because substantial non-tax related cash returns or other profits

may exist in those investments that would preclude them from applying the guidance in the proposed Update.

17. For other tax credit investments, the credit periods are typically shorter than 10 years (the credit period for LIHTC). For example, the tax credit period is seven years for New Markets tax credits, and one year (received in the year the underlying property is placed in operation) for both Renewable Energy and Historic tax credits. Although each investment type has its unique tax credit calculation and allocation methods, if substantially all of the investor's returns are generated from tax credits and other tax benefits, and if all other conditions in the proposed Update are met, the FASB staff believes that the use of the proportional method should also be allowed for investments in other tax credits. Otherwise, investors would have to apply different accounting methods for economically similar investments.

18. As noted in previous issue summaries, tax laws require a profit motive for certain tax credit investments (to qualify for the tax credits) but not for others. The FASB staff believes that the profit motive requirement should not drive an investor's accounting for the tax credit investments. The FASB staff acknowledges that the conditions may be more difficult to meet for tax credit investments that have a required profit motive (such as Historic tax credits), because to qualify for the tax credits the investor would have to seek a higher proportion of its returns in non-tax benefits, thereby violating the condition in the proposed Update that substantially all returns should result from tax credits and other tax benefits. However, if the conditions in the proposed Update are satisfied, the FASB staff believes that a tax law requirement for a profit-motive alone should not preclude an investor from qualifying for the proportional method of accounting.

19. Based on the feedback received and the aforementioned reasons, the FASB staff believes that the scope of the proposed guidance should be extended to all tax credit investments that meet the revised amended conditions in the proposed Update. At a minimum, the FASB staff believes that the Task Force should permit application of the LIHTC guidance by analogy to all investments in tax credits that meet the proposed conditions. The FASB staff notes that almost all stakeholders expressed a preference to affirm this proposal and issue a final Update regardless

of whether the Task Force decides to expand the scope beyond LIHTC. Therefore, if the Task Force determines that the proposed Update should be re-exposed due solely to the expansion of scope, the FASB staff believes that the Task Force should finalize the guidance in the proposed Update for LIHTC investments first. Considerations about whether to issue a revised Exposure Draft are discussed later in this Issue Summary Supplement.

Other Transactions between the Investor and the Limited Liability Entity

20. The Task Force tentatively decided that other transactions, such as bank loans, between the investor and the limited liability entity should not be considered in determining whether the conditions in the proposed Update are met, provided that (a) the reporting entity is in the business of entering into those transactions, (b) those transactions are entered into at market rates commensurate to rates offered to other counterparties with similar credit quality, and (c) the transactions do not give the reporting entity the ability to exercise significant influence over the operating and financial policies of the limited liability entity. However, in discussing whether or not to expand the scope of the proposed Update to include other types of tax credit investments, some Task Force members expressed concern that there may be unintended consequences if the guidance in the proposed Update were applied to other types of tax credit investments. This concern was highlighted especially when there were other transactions between the investor and the limited liability entity that had not been contemplated in the development of the proposed Update. During the FASB staff outreach, no other transactions between the investor and the limited liability entity were identified other than the investment itself and the loans.

21. Based on the feedback provided, the FASB staff believes that the provision in the proposed Update that deals with other transactions also appropriately applies to other types of tax credit investments. Therefore, the FASB staff also recommends retaining the other-transactions provision even if the scope is extended to all tax credit investments that meet the revised amended conditions.

Question 2 for the Task Force: Does the Task Force agree with the FASB staff recommendation to expand the scope of the proposed Update to include all tax credit investments that meet the revised amended conditions?

Use of Other Tax Benefits under the Proportional Amortization Method

22. Although it was not a specific follow-up item, during the FASB staff's outreach, stakeholders expressed concern about the Task Force's tentative decision that prescribes the use of both tax credits and other tax benefits in the amortization calculation. Stakeholders noted that they would prefer an amortization model based solely on tax credits because the benefits to investors of a more precise amortization method do not justify the complexity associated with that method. Some stakeholders acknowledged that the inclusion of other tax benefits in the amortization model is conceptually more accurate and consistent with the qualifying condition for the proportional method. However, they noted that the complexity associated with periodically estimating tax losses, in some cases, generated from hundreds of investments in multiple tax jurisdictions would be overly burdensome. While total other tax benefits are estimable upfront with reasonable accuracy (because total tax deductions generally cannot exceed an investment's original tax basis), periodic calculations of tax losses are often performed based on estimates and trued-up in subsequent periods when tax returns are filed. Furthermore, stakeholders asserted that in many cases investors would not be required to estimate other tax losses upfront for purposes of assessing the conditions in the proposed Update because tax credits alone would demonstrate that there is positive yield. Stakeholders brought up the following additional complexities arising from the tentative decision to use other tax benefits in the amortization calculation:

a. This tentative decision would create an exception to the deferred tax accounting guidance and would create complexity for financial statement preparers. The FASB staff originally thought that eliminating the deferred tax requirement would be easier for preparers. However, preparers noted that it is more operationally difficult to deal with exceptions in deferred tax accounting.

b. After all tax credits are utilized (for example, after year 10 of a LIHTC investment,) the investment's book balance would be merely supported by the benefit that would result from the "write-off" of the remaining investment (through tax losses). While most agree that the tax deductions would generate future economic benefit for the reporting entity, many constituents believe impairment may be necessary at that time because the investment no longer generates tax credits and has no value to market participants.

d. Periodic changes, even temporary changes, in federal and state tax regulations (such as bonus depreciation elections arising from stimulus programs) would introduce incremental complexity to the amortization calculation.

e. The day-to-day operations of the projects that, in part, influence the timing of tax deductions would affect an investor's timing of amortization when the investor has no significant involvement in the operations of the investment and is investing for a longer-term investment return.

23. At the September EITF meeting, the Task Force expressed concern that a tax-credit-only amortization method may not be appropriate for other (non-LIHTC) investments, particularly if the tax credits are earned in one year (as in the case of Historic tax credits when the property is placed in service). The FASB staff has learned that even in those cases, it might be appropriate to amortize 100 percent of the investment because the tax credit would still need to be the primary source of return for the investment to meet the conditions in the proposed Update. In other words, since other tax deductions generally cannot exceed the total amount invested by the investor, to achieve a positive yield based solely on tax-related benefits, a significant portion of the investor's return would have to be in tax credits.

24. The FASB staff had recommended at the September EITF meeting that the amortization method should be based solely on tax credits. On the basis of the additional information obtained from stakeholders, the FASB staff continues to believe that an amortization method based solely on tax credits would still appropriately reflect the pattern of primary benefits (tax credits) in a cost-effective manner for <u>all</u> tax credit investments. Alternatively, if the Task Force does not want to prescribe the specific inputs to the amortization method, the FASB staff believes that a more principles-based approach can be sought, such as the following:

> An investment in tax credits that meets the conditions in paragraph 323-740-25-XX shall be amortized based on the pattern of the primary economic benefits received from the investment. When tax credits are the primary source of economic benefit, the pattern of tax credits shall be used. Otherwise, if the tax credits are not the primary source of economic benefit, the pattern of both tax credits and other tax benefits shall be used in estimating the periodic amortization of the investment.

25. Further, if the Task Force agrees with the FASB staff recommendation to use tax credits (or the principle above), the FASB staff believes that the Task Force should not change the existing deferred tax accounting on temporary differences for tax credit investments because doing so would result in an exception to deferred tax accounting and would be operationally difficult for some reporting entities. Additionally, differences between the book and tax basis of the investment will exist because the investment is an operating entity that collects rent, maintains loans to fund the project and depreciates the property and equipment. The staff notes this issue is primarily about how to account for tax credit investments, including the calculation and the income statement presentation of the related amortization. This Issue was not intended to change how entities should account for taxes on these investments; thus, the staff believes that the actual tax credits, the other tax benefits, and all of related deferred tax accounting implications should continue to be accounted for under existing U.S. GAAP.

Question 3 for the Task Force: Does the Task Force agree with the FASB staff recommendation to either (a) prescribe that only tax credits should be used in applying the proportional method of amortization or (b) introduce a principle premised on the primary benefit of the investment as articulated above?

Consideration of a Revised Exposure Draft

26. Because the Task Force's tentative decisions reached at the September EITF meeting and discussed above would result in a change to the consensus-for-exposure, the FASB staff has considered whether a revised Exposure Draft is warranted. A revised Exposure Draft is generally required when there has been a substantive change to the scope or to the main recognition, measurement, or disclosure principles. The intent of a revised Exposure Draft is to allow

constituents to have an opportunity to raise issues or concerns not previously considered by the Task Force.

27. One factor to consider in evaluating re-exposure is the extent to which decisions reached by the Task Force during its redeliberations of a proposed Update resulted in a substantive change to the guidance in the proposed Update on which respondents commented (individually and/or in the aggregate). A substantive change usually does not result from a change based on input provided by respondents in comment letters, including input on alternative approaches to resolve an issue.

28. In this case, the tentative decision made by the Task Force to revise the amended condition in paragraph 323-740-25-1(aa) of the proposed Update to reference "significant influence" instead of "no operational influence other than protective rights," and the decision to change the method of accounting from the effective yield method to the proportional amortization method were based on the direct input provided by comment letter respondents and through outreach. Comment letter respondents also provided input about the consideration of other transactions, such as bank loans, between the investor and the limited liability entity in applying the guidance in the proposed Update, and about whether or not to expand the scope of the proposed guidance to include other tax credit investments.

29. Certain other tentative decisions were reached that were not in direct response to comments received from stakeholders on the proposed Update, as follows:

a. **Deferred Tax Asset Classification:** The investment should be classified as a deferred tax asset. The proposed Update had not prescribed a balance sheet presentation.
b. **Deferred Taxes on Basis Differences:** Deferred taxes on the book and tax basis differences in the investment should not be recorded. The proposed Update had not prescribed deferred tax accounting considerations.
c. **Reevaluation of Investments:** A reporting entity should evaluate its eligibility to use the guidance in the proposed Update (a) on the basis of facts and conditions that existed at the time of the initial investment and (b) upon a change in the nature of the investment or

in the relationship with the limited liability entity that could result in the reporting entity no longer meeting the conditions to be able to use the guidance in the proposed Update. The proposed Update had not provided guidance on when and how to reevaluate a LIHTC investment.

d. **Impairment:** A reporting entity should test a LIHTC investment for impairment when it is more likely than not that the investment will not be realized through the receipt of tax credits and other tax benefits (similar to a valuation-allowance model). The proposed Update had not prescribed an impairment approach.

e. **Transition:** A reporting entity that uses the effective yield method to account for its LIHTC investments prior to the date of adoption of the proposed amendments would be permitted to continue to apply the effective yield method for those LIHTC investments upon transition. The proposed Update had not provided any exceptions to retrospective transition.

30. The FASB staff believes that changes resulting from the tentative decisions discussed in paragraph 27 above, except for the deferred tax asset presentation in paragraph 27(a), either do not constitute substantive changes from the proposed Update or can be justified based on direct feedback from constituents. As discussed earlier, constituents unanimously opposed the deferred tax asset presentation decision in (a). The elimination of deferred tax accounting decision in (b) was a part of the decision to change from an effective yield to a proportional method (based on tax credits and other tax benefits.) The reevaluation and impairment related decisions in (c) and (d) were not new decisions but rather decisions to operationalize the proposed conditions in a way that reflects the appropriate accounting method and measurement when there are changes in circumstances. Finally, the decision on transition in (e) was a practical accommodation for those investors that currently apply the effective yield method.

31. In determining whether a revised Exposure Draft should be issued, other factors to consider include whether constituents have had sufficient opportunity to fully consider the implications of the change and communicate their views on the change (for example, through comment letters, roundtable meetings, and constituent outreach activities during redeliberations) and whether the Task Force would benefit in its decision making from additional input on the revised

amendments, considering the extent to which such input would provide new information not previously considered by the Task Force.

32. The FASB staff believes that it has received sufficient input from both the comment letters and the subsequent outreach on all key decisions, including scope. The FASB staff also believes that stakeholders had sufficient opportunity to consider the implications of all of the tentative decisions with one exception: the deferred tax asset presentation. If the tentative decision to present investments as deferred tax assets is not affirmed as a consensus, the FASB staff recommends that a revised exposure draft would not be necessary and a final Update can be issued.

Question 4 for the Task Force: Does the Task Force believe that a revised Exposure Draft should be issued?