INSIGHTS

Final Standard Issued on Accounting for Affordable Housing Tax Credit Investments—An In-Depth Look

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On January 15, 2014, the Financial Accounting Standards Board (FASB) issued ASU 2014-01, "Accounting for Investments in Qualified Affordable Housing Projects," (ASU 2014-01 or Update) which represents a consensus of the Emerging Issues Task Force (Task Force) and sets forth new accounting for qualifying investments in flow-through entities. ASU 2014-01 amends the existing guidance in ASU 323-740.

Summary

The primary provisions of ASU 2014-01 allow for the cost of an investment in an affordable housing project to be amortized and the resulting expense to be reflected as a component of the investor's income tax provision rather than its operating income. The new accounting method, referred to as the "proportional amortization method", will allow amortization of the tax credit investment to be reflected along with the primary benefits, the tax credits and other tax benefits, on a "net, net basis" on the income tax expense line of the income statement.

Previous guidance allowed for use of the effective yield method for qualifying investments. However qualifying for the effective yield method was difficult and resulted in only a small percentage of tax credit investments qualifying for that method. All other investments were required to follow traditional accounting for equity investments under Topic 323, "Investments – Equity Method and Joint Ventures," which generally resulted in use of the equity method. Under the equity method, the investor's portion of investee earnings is reported separately from the tax credits and other tax benefits. Separate reporting of the operating results of the investment, which virtually always generated losses, from the primary benefits of the investment, generally included in the income tax provision, made it difficult to understand the real investment performance of these investments.

What Does CohnReznick Think? The proportional amortization method is likely to benefit most investors. Operating income will no longer be depressed by the equity losses attributable to their affordable housing investments. This will mean, among other things, that investors will no longer need to make adjustments to true up their equity method losses when explaining investment performance.

Conditions to Use Proportional Amortization Method

In order to qualify for the proportional amortization method, all of the following conditions must be met:

a. The availability of the tax credits allocable to the investor must be probable.

b. The investor cannot have the ability to exercise significant influence over the operating and financial policies of the investee.

c. Substantially all of the projected benefits from the investment must come from tax credits and other tax benefits.

d. The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits must be positive.

e. The investor must be a limited liability investor for both legal and tax purposes, and the investor's liability must be limited to the amount of its capital investment.

Applying the above conditions will require investors to make several judgments along the way, many of which are addressed below.

Availability of Tax Credits Is Probable

One of the more straightforward conditions is the requirement that the availability of the tax credits allocable to the investor must be probable. Because of the high threshold associated with the use of the term probable (meaning the future event(s) is (are) likely to occur), we believe a question arises regarding whether an investment would qualify for the accounting before a final allocation of tax credits has been made by the governing state agency, as evidenced by the issuance of a final Form 8609(s) or its equivalent. The degree of uncertainty regarding the availability of tax credits is more significant prior to the point when a final allocation is made.

An additional uncertainty regarding availability exists prior to achievement of sufficient rent-up by qualified tenants necessary to meet the minimum set-aside requirements. Prior to meeting the minimum set-aside requirements no tax credits can be claimed, regardless of whether a final allocation has been made.

What Does CohnReznick Think? It would be reasonable to conclude that the availability of housing credits is probable once a qualified housing credit project has received a reservation of credits from the state housing credit agency. However, both the Form 8609 and minimum set-aside test hurdles must be cleared before housing credits can be reported on the tax return of the project entity and passed through to investors. Accordingly, we believe that investors should not begin application of the proportional amortization method prior to the reporting period when these requirements are expected to be met and housing credits are expected to be claimed.

No Ability to Exercise Significant Influence Over the Investee

Generally, investors have specified rights related either to their ownership interest in a housing credit fund or directly in affordable housing projects. In order to evaluate whether or not those rights provide the investor with significant influence over the operating and financial policies of the investee an investor has to consider whether or not the indicators of significant influence set forth in ASC 323-10-15-6 through 15-7 are present. Those indicators are summarized below:

a. Representation on the Board of Directors
b. Participation in policy-making processes
c. Material intra-entity transactions
d. Interchange of managerial personnel
e. Technological dependency
f. Extent of ownership by investor in relation to the concentration of other shareholdings

The conditions under ASC 323-10-15-6 through 15-7 were intended for application to investments in common stock and not to investments in limited liability partnership interests. A logical question is whether ownership of a 99% limited liability investment creates a presumed expectation that the investor can exercise significant influence. The FASB addressed this issue by specifically excluding the presumption that an investment of 20% or more provides the investor with significant influence over the investee.

The most likely scenario where an investor may be deemed to have significant influence will be when the investor participates in running the day-to-day operations of the project. For example, some investors may have the right to approve operating budgets and certain other significant decisions initially made by the general partner. Investors may also have the right to approve the selection of a new management agent, the amount of their management compensation and other business terms. Participation of this type should be carefully analyzed to determine whether it constitutes significant influence over the operations of the investee, or merely provides the investor with an opportunity to oversee the general partner's performance.

What Does CohnReznick Think? Significant influence is more likely to exist in situations where the investor also participates in the operating cash flows of the entity. Approval of the management agent's fee would not necessarily constitute significant influence if the amount of the fee is commensurate with the prevailing market rate for property management services. By contrast, if the investor has some level of control over the project's operating or replacement reserves, the company may be found to have significant influence on project operations.

Significant influence involving tax credit funds

Another question that may arise is whether an investor in a tax credit fund needs to consider whether or not the fund has significant influence over the operations and financial policies of the affordable housing project(s) in which it is invested. In other words, does the investor need to look through the fund to its underlying investments?

We believe that the determination of whether the investor has significant influence normally should be made at the entity in which it has invested, typically a tax credit fund of some type. In the case of a direct investment in an affordable housing project, the determination would be made at the project level. However, an investor in a tax credit fund would not be considered to have significant influence over the operating and financial policies of an affordable housing project unless: i) the tax credit fund had significant influence over the affordable housing project; and ii) the investor controlled or had significant influence over the tax credit fund.

Substantially All of the Projected Benefits From the Investment Must Come from Tax Credits and Other Tax Benefits

In order to qualify as a tax credit investment, substantially all (greater than 90%) of the projected benefits must come from the tax credits and other tax benefits and not from operating cash flows or residual values of the underlying real estate. This requirement does not preclude an investor from participating in any projected cash benefits or from receiving distributions of cash from investments.

Investments projected to provide investors with cash benefits in excess of 10% of the total amount of benefits may find it difficult to meet the substantially all condition. The important point for investors to remember is that investments with projected benefits other than the tax credits and other tax benefits will be less likely to qualify for the proportional amortization method.

Combination tax credit investments

Application of ASU 2014-01 is limited to investments in affordable housing projects. However, some investments may also include other types of tax credits, such as historic tax credits, new markets tax credits, or renewable energy investment tax credits. The impact of other types of tax credits on whether or not the investment qualifies for the proportional amortization method will depend on a number of considerations, including whether the investment entity is primarily an affordable housing project.

For example, an entity that is awarded an allocation of affordable housing tax credits might also qualify for historic tax credits. The historic tax credits will likely be based on substantially the same depreciable costs as the affordable housing tax credits. The investor in the project may be entitled to receive its proportionate share of both the affordable housing tax credits and the historic tax credits. For purposes of this example we will assume that the project is subject to the affordable housing compliance requirements and is subject to a land use restriction agreement. The amount of historic tax credits is based on 20% of qualified rehabilitation expenditures. As a result, the level of historic tax credits will be significantly lower than and, therefore, ancillary to, the amount of affordable housing tax credits.

In such a situation, a question arises regarding whether the historic tax credits should be included or excluded from the amount of tax credits and other tax benefits for purposes of meeting the substantially all condition.

Although this issue is not specifically addressed in the Update, we believe the answer lies in determining first, whether the investee is considered an affordable housing project, and second, whether the primary purpose of the investment is to obtain affordable housing tax credits.

The question of whether the investee is considered an affordable housing project would turn on an analysis of the nature of its operations and whether the affordable housing tax credits are the predominant tax credit allocated to the project. A principal consideration related to whether the primary purpose of the investment was to obtain affordable housing tax credits would be based on whether the amount of affordable housing tax credits allocated to the investor is greater than the amount of the other tax credits allocated to the investor.

In other words, an investment in an entity that is considered to be an affordable housing project and where the investment consists primarily of affordable housing tax credits, but also includes a smaller amount of historic tax credits arguably should include the historic tax credits (or other types of tax credits) in the amount of tax credits and other tax benefits for purposes of meeting the substantially all condition.

On the other hand, an investment made to obtain historic tax credits that also receives a small amount of affordable housing tax credits arguably should exclude the historic tax credits (or other types of tax credits) from the amount of tax credits and other tax benefits for purposes of meeting the substantially all condition.

Cash flows received by tax credit funds

Investors in tax credit funds should apply the substantially all condition to their investment at the fund level. Tax credit funds often receive cash flow distributions from individual property investments which need to be used to pay current and accrued asset management fees. As a result, most fund investors do not receive cash distributions from the funds in which they are invested.

Accounting by Tax Credit Funds for Their Investments

Tax credit funds make direct investments in affordable housing projects. The question is whether tax credit funds are eligible to use the proportional amortization method. We believe that investments in affordable housing projects made by tax credit funds will not qualify for the proportional amortization method. Tax credit funds, which are flow-through entities, will not be able to meet the substantially all condition. In fact, because the tax credit fund is not a tax-paying entity, none of its projected benefits will come from the tax credits and other tax benefits. Rather, those projected benefits will be passed through to the fund's investors. As a practical matter, a tax credit fund could not apply the proportional amortization method since two of the primary components, the tax credits and other tax benefits are not reported in earnings at the tax credit fund level. Additionally, a tax credit fund could not report the resulting amortization of its investment in accordance with the Update since it does not have a tax provision in its income statement.

What Does CohnReznick Think? We would expect tax credit funds to continue to account for their investments in affordable housing projects using the equity method. This is consistent with how tax credit funds historically have accounted for investments in affordable housing projects that qualify for the effective yield method.

Additionally, not all investors in a given tax credit fund may elect to apply the proportional amortization method.

Tax credit funds also have other components of earnings that would not follow the proportional amortization method, such as asset management fee expense and amortization related to intangible assets.

Accounting by Investors that Consolidate Their Investments in Tax Credit Funds

Investors that hold investments in tax credit funds that are consolidated (the investor has made the determination that the tax credit fund is a variable interest entity and that they are the primary beneficiary – which is most likely to occur in proprietary fund situations) will need to apply the conditions under the Update to each investment held by the fund. Only the investments in affordable housing projects that meet the conditions will be eligible for the proportional amortization method. All other assets, liabilities, revenues, and expenses of the consolidated fund will be unaffected by the Update. To the extent that some investments held by the consolidated tax credit fund do not qualify for the proportional amortization method, those investments would continue to be accounted for under the equity method.

Since it is likely that the stand alone financial statements of the tax credit fund will be prepared using the equity method of accounting, any investor that consolidates will need to adjust the fund's financial statements to reflect the effects of the proportional amortization method on qualifying investments.

Accounting by Investors that Do Not Consolidate Their Investments in Tax Credit Funds

Investors that hold investments in tax credit funds that are not consolidated (the investor has made the determination that the tax credit fund is a variable interest entity but has determined that they are not the primary beneficiary – which is most likely to occur in multi-investor fund situations) will need to apply the conditions under the Update to its investment in the tax credit fund. Investors would not need to look through to whether the individual investments held by the tax credit fund individually meet all the conditions. Rather, the conditions would be viewed on an aggregate basis at the investment level, which is the investment in the tax credit fund.

Accounting Policy Decision

The election to use the proportional amortization method is an accounting policy decision and must be applied to all qualifying investments in affordable housing projects. It is not an election applied on an investment-by-investment basis. Current investments which qualify for the effective yield method are permitted to continue to apply the effective yield method. However, any new investments would need to be accounted for using the proportional amortization method.

If an investor chooses not to apply the proportional amortization method to qualifying investments, they are required to account for those investments in accordance with ASC 970 – 323 using the equity method.

Application of the Proportional Amortization Method

Mechanically, ASU 2014-01 specifies that the proportional amortization method should be computed by incorporating both the amount of the tax credits as well as the other tax benefits. However, the Update allows a practical expedient to be used which allows the investor to compute the proportional amortization based solely on the tax credits as long as the investor reasonably expects that doing so will produce a measurement that is "substantially similar" to the measurement that would result from using both the tax credits and the other tax benefits.

The practical expedient usually will result in amortization of the investment that is substantially similar in amounts on an annual basis to the amortization that would result from a calculation incorporating both the tax credits and other tax benefits.

In the example in the Update, the other tax benefits are based on tax losses which are estimated to equal the amount of tax depreciation which would result in complete amortization of the investment over a 15-year period. It is unlikely that actual tax losses will be so cooperative. Investors that incorporate tax losses into the calculation will likely need to rely on projected tax losses since actual tax losses will not be known timely enough to be used in the calculation and could change annually. Investors that attempt to obtain more updated tax losses may find the process difficult without producing any worthwhile improvement in the results.

What Does CohnReznick Think? We anticipate that many investors will opt to calculate amortization based on the practical expedient since it (a) will provide the clearest reflection of income (in most cases) and (b) will be far easier to administer. When evaluating whether the practical expedient will produce a measurement that is "substantially similar" to the measurement that would result from using both the tax credits and the other tax benefits, we recommend that investors also consider whether including the other tax benefits will produce a measurement that will sufficiently amortize the investment over the expected holding period.

The examples on the following page, which are based on the Update, illustrate proportional amortization calculated using both the tax credits and the other tax benefits (the FASB Example) and the amortization calculated just using the tax credits (the Practical Expedient).

Items that could cause dissimilar results

Using the practical expedient could result in amortization that is not substantially similar during the initial years of the investment when significant amounts of accelerated depreciation deductions are expected or where other tax credits exist.

FASB Example

Investment	$ 100,000	Tax Credits	$ 80,000	Tax Rate	40%	Depreciable Basis	$ 200,000

Year	EOY Investment	Amortization	Tax Credits	Tax Losses	Other Tax Benefits	Tax Credits & Other Tax Benefits	Tax Credits & Other Tax Benefits, Net of Amortization	EOY Tax Investment
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1	90,909	9,091	8,000	7,273	2,909	10,909	1,818	92,727
2	81,818	9,091	8,000	7,273	2,909	10,909	1,818	85,454
3	72,727	9,091	8,000	7,273	2,909	10,909	1,818	78,181
4	63,636	9,091	8,000	7,273	2,909	10,909	1,818	70,908
5	54,545	9,091	8,000	7,273	2,909	10,909	1,818	63,635
6	45,454	9,091	8,000	7,273	2,909	10,909	1,818	56,362
7	36,363	9,091	8,000	7,273	2,909	10,909	1,818	49,089
8	27,272	9,091	8,000	7,273	2,909	10,909	1,818	41,816
9	18,181	9,091	8,000	7,273	2,909	10,909	1,818	34,543
10	9,090	9,091	8,000	7,273	2,909	10,909	1,818	27,270
11	6,666	2,424	-	7,273	2,909	2,909	485	19,997
12	4,242	2,424	-	7,273	2,909	2,909	485	12,724
13	1,818	2,424	-	7,273	2,909	2,909	485	5,451
14	-	1,818	-	5,451	2,183	2,183	365	-
15	-	-	-	-	-	-	-	-
Totals		**100,000**	**80,000**	**100,000**	**40,000**	**120,000**	**20,000**	

Assumptions

- Original investment = $100,000
- Total tax credits = $80,000 ($8,000 annually for 10 years)
- Depreciable basis = $200,000
- Tax depreciation is based on 27.5 years computed on a straightline basis

Column Explantions

- (a) = PY Balance - (b)
- (b) = [(c) + (e)] / [Σ(c) +Σ(e)] x Investment
- (c) = Total tax Credits / 10
- (d) = Depreciable Basis / 27.5 yrs
- (e) = (d) x 40%
- (f) = (c) + (e)
- (g) = (f) - (b)
- (h) = PY tax balance - (d)

Practical Expedient

Investment	$ 100,000	Tax Credits	$ 80,000	Tax Rate	40%	Depreciable Basis	$ 200,000

Year	EOY Investment	Amortization	Tax Credits	Tax Losses	Other Tax Benefits	Tax Credits & Other Tax Benefits	Tax Credits & Other Tax Benefits, Net of Amortization	EOY Tax Investment
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
1	90,000	10,000	8,000	7,273	2,909	10,909	909	92,727
2	80,000	10,000	8,000	7,273	2,909	10,909	909	85,454
3	70,000	10,000	8,000	7,273	2,909	10,909	909	78,181
4	60,000	10,000	8,000	7,273	2,909	10,909	909	70,908
5	50,000	10,000	8,000	7,273	2,909	10,909	909	63,635
6	40,000	10,000	8,000	7,273	2,909	10,909	909	56,362
7	30,000	10,000	8,000	7,273	2,909	10,909	909	49,089
8	20,000	10,000	8,000	7,273	2,909	10,909	909	41,816
9	10,000	10,000	8,000	7,273	2,909	10,909	909	34,543
10	-	10,000	8,000	7,273	2,909	10,909	909	27,270
11	-	-	-	7,273	2,909	2,909	2,909	19,997
12	-	-	-	7,273	2,909	2,909	2,909	12,724
13	-	-	-	7,273	2,909	2,909	2,909	5,451
14	-	-	-	5,451	2,183	2,183	2,183	-
15	-	-	-	-	-	-	-	-
Totals		**100,000**	**80,000**	**100,000**	**40,000**	**120,000**	**20,000**	

Assumptions

- Original investment = $100,000
- Total tax credits = $80,000 ($8,000 annually for 10 years)
- Depreciable basis = $200,000
- Tax depreciation is based on 27.5 years computed on a straightline basis

Column Explantions

- (a) = PY Balance - (b)
- (b) = (c) / Σ(c) x Investment
- (c) = Total tax Credits / 10
- (d) = Depreciable Basis / 27.5 yrs
- (e) = (d) x 40%
- (f) = (c) + (e)
- (g) = (f) - (b)
- (h) = PY tax balance - (d)

What Does CohnReznick Think? In the absence of any extenuating factors, use of the practical expedient normally should provide amortization results which are substantially similar to those based on both the tax credits and other tax benefits.

Impairment

Investments in affordable housing projects are required to be tested for impairment when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized. Situations which might indicate that the investment will not be realized would include a determination that it is more likely than not that the expected tax credits and other tax benefits would not be received. Further, impairment could exist in situations where the investor decides to sell its investment on the market, rather than receive the tax credits and other tax benefits.

Other Matters

Other Transactions Between Investors and Investees

Under ASU 2014-01, other transactions between the investor and the investee are not required to be considered when determining whether the condition have been met so long as the following conditions are met:

- The investor is in the business of entering into those other transactions.
- The terms of those other transactions are consistent with the terms of arm's-length transactions.
- The reporting entity does not acquire the ability to exercise significant influence over the operating and financial policies of the investee as a result of those other transactions.

Accordingly, a bank or other entity could provide the investee with a loan provided the above conditions were met. Other transactions could pose larger questions in situations where the investor is not in the business of entering into the other transactions. A common situation could be where the investor is not in the business of making loans and nevertheless advances funds to the investee. Such advances are not unusual. Usually they are limited to advancing funds which are expected to be repaid through remaining future capital installments of the original investment. Judgment will need to be applied in order to determine whether such advances truly represent other transactions between the investor in the investee. Arguably such advances could be viewed as part of the original investment and not as other transactions.

Reassessment of Investment Qualifications

Application of the proportional amortization method is made at the time of the initial investment. Investors are required to reevaluate the conditions upon the occurrence of either of the following:

- A change in the nature of the investment.
- The change in the relationship with the investee that could result in the investor no longer meeting the conditions.

The likelihood of either of the above occurring should be low. ASU 2014-01 provides an example of a change in the nature of the investment, illustrated by a situation where the investment is no longer in a flow-through the entity for tax purposes. Similarly, the change in the nature and investment could occur if the investor makes a decision to sell the investment before receipt of the tax credits.

Changes in the relationship with the investee generally would only occur if the general partner in the affordable housing project needed to be replaced as a result of performance issues or if the investor changes the nature and amounts of its investment.

What Does CohnReznick Think? Small changes in the amount of the investment resulting from receipt of additional tax credits or from the application of tax credit adjusters should not result in any reassessment. However, if the investor is required to become more involved in the day-to-day operations of the affordable housing project or if the investor is required to provide additional subordinated financial support over and above its original investment, then a reassessment should be performed.

Residual Values

Residual values are excluded from the projection of expected benefits in calculating the amount ofproportional amortization. Tax credit investments qualifying for the proportional amortization method should not have any expected significant residual values. Investors should be careful when considering this issue since significant residual value could result in failure to satisfy the substantially all condition. Gains or losses on sale of investments, if any, are included in earnings at the time of sale.

Early Adoption Considerations

Investors can early adopt the provisions of ASU 2014-01. However, application of the ASU must be made on a retrospective basis to all periods presented. Accordingly, investors will need to determine which investments qualify for the proportional amortization method. Additionally, investors will need to determine whether or not they will utilize the practical expedient (and whether it will produce substantially similar results). The principal consideration is the potential impact the proportional amortization method would have on the investor's income statement, especially pre-tax earnings, as a result of reporting amortization of the investment as a component of its income tax provision.

Disclosures

The disclosure requirements under ASU 2014-01 are fairly straightforward and should not present investors with any significant difficulties. Investors which have a mixed bag of investments, where some of the investments meet the conditions for application of the proportional amortization method while others do not, will face the most difficulty.

A brief summary of the disclosure requirements required under the Update is set forth below:

a. The amount of affordable housing tax credits and other tax benefits recognized during the year.

b. The net carrying value of the investment recognized in the balance sheet.

c. For qualified affordable housing project investments accounted for using the proportional amortization method, the amount recognized as a component of income tax expense.

d. For qualified affordable housing project investments accounted for using the equity method, the amount of investment income or loss included in pretax income.

e. Any commitments or contingent commitments, including the amount of equity contributions in the year or years in which such contingent commitments are expected to be paid.

f. The amount and nature of impairment losses during the year resulting from the forfeiture or ineligibility of tax credits or other circumstances.

Questions

Clients who have specific questions regarding the proposed Update may contact their CohnReznick partner for assistance. Other individuals that have specific questions regarding the proposed Update may contact Michael C. Beck at 404-847-9447.

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