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REACHING THE PINNACLE | Practice aid

Accounting for equity investments in income tax credit programs

Implementing ASU 2023-02 (ASC 323-740)

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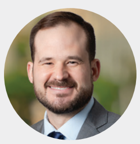

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INTRODUCTION

We are pleased to bring you this practice aid that addresses the accounting for equity investments in income tax credit structures, including the proportional amortization method (PAM) of accounting, the equity method of accounting, application of Topic 321, "Investments – Equity Securities," and consolidation considerations.

The Financial Accounting Standards Board (FASB) introduced PAM in Accounting Standards Update (ASU) 2014-01, "Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects." PAM provides a preferential income statement presentation by presenting the amortization of the equity investment in the same line item in which the income tax credit benefits are recorded: income tax expense (benefit).

At the time ASU 2014-01 was issued, application of PAM was limited to eligible equity investments in low-income housing tax credit (LIHTC) structures.

Given the expansion and nature of tax credit investments, stakeholders requested expansion of PAM to economically similar investments. During initial outreach, the staff found consensus to proceed with a project. In March 2023, the FASB issued ASU 2023-02, "Investments – Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method," expanding the use of PAM to equity investments beyond those in the LIHTC program.

The following table highlights some of the programs to which the guidance in this practice aid applies.

Program	Program description
Low-income housing tax credit (LIHTC)	Tax credits awarded based on the operation of low-income housing projects
New market tax credit (NMTC)	Tax credits awarded based on economic expansion to designated areas
Historical rehabilitation tax credit (HTC)	Tax credits awarded based on restoration of designated historic sites
Renewable energy tax credit (RETC)	Production-based or investment-based tax credits from the creation of energy through renewable projects
State-specific tax credit programs	Varies by each state-sponsored program

This practice aid addresses the accounting for equity investments in *income* tax credit structures. It does not address investments in non-income-tax credits, such as payroll tax credits, research and development tax credits, sales tax credits, or the accounting for the purchase of productive assets that generate tax credits. Entities should apply other relevant generally accepted accounting principles (GAAP) to those investments.

We hope you find this practice aid useful, and we welcome your feedback.

OVERVIEW OF ACCOUNTING MODELS

General considerations

Equity investors in a tax credit project can have multiple forms of involvement with the project. For example, it is not uncommon for an investor to provide both equity and debt financing to a project. Other forms of involvement might include, but are not limited to, financial or performance guarantees.

This practice aid focuses on how an investor accounts for an *equity* investment in an income tax credit project. Other forms of involvement, such as a loan or a guarantee, should be accounted for in accordance with other GAAP. However, to determine the appropriate accounting for its equity investment, an investor might need to consider the terms and conditions of its other forms of involvement. For example, the terms of a loan agreement might provide the investor with significant influence or control over the project, which would affect how the investor accounts for its equity investment.

The following table summarizes the possible accounting outcomes for equity investments in income tax credit projects.

Accounting outcome	Considerations
Consolidation (Topic 810[1])	In the **variable interest entity (VIE) model,** an investee is consolidated when the investor has power over the most significant activities of the investee and potentially significant exposure to losses or gains of the investee. The VIE model applies when either 1) the investee's total equity at risk is not sufficient to permit the investee to finance its activities without additional subordinated financial support, or 2) as a group, the investee's equity investors lack the power to direct the significant activities of the investee, an obligation to absorb expected losses, or the right to receive expected residual returns.[2] In the **voting interest equity (VOE) model,** an investee generally is consolidated if the investor holds a majority of voting (or kick-out) rights of the investee. This model applies when the investee is not subject to the VIE model.
Proportional amortization method (Subtopic 323-740)	**PAM** is applied when the investor does not meet consolidation criteria for the investee, the investment is in an income tax credit program to which the investor has elected to apply PAM, and the investment meets the qualifying criteria in Accounting Standards Codification (ASC) 323-740-25-1.
Equity method (Topic 323[3]) or Topic 321	If the investor elects to not apply PAM or the individual investment does not qualify for PAM, one of the following will apply: **Equity method (Topic 323)** is applied when an investor can exercise significant influence over the operating and financial policies of the investee. In practice, an equity investment of greater than 3% to 5% generally would provide the investor with significant influence. **Topic 321** is applied when the equity investment is so minor that the investor has virtually no influence over the investee's operating and financial policies. In practice, this generally is interpreted as instances in which the investor's equity interest is less than 3% to 5%.

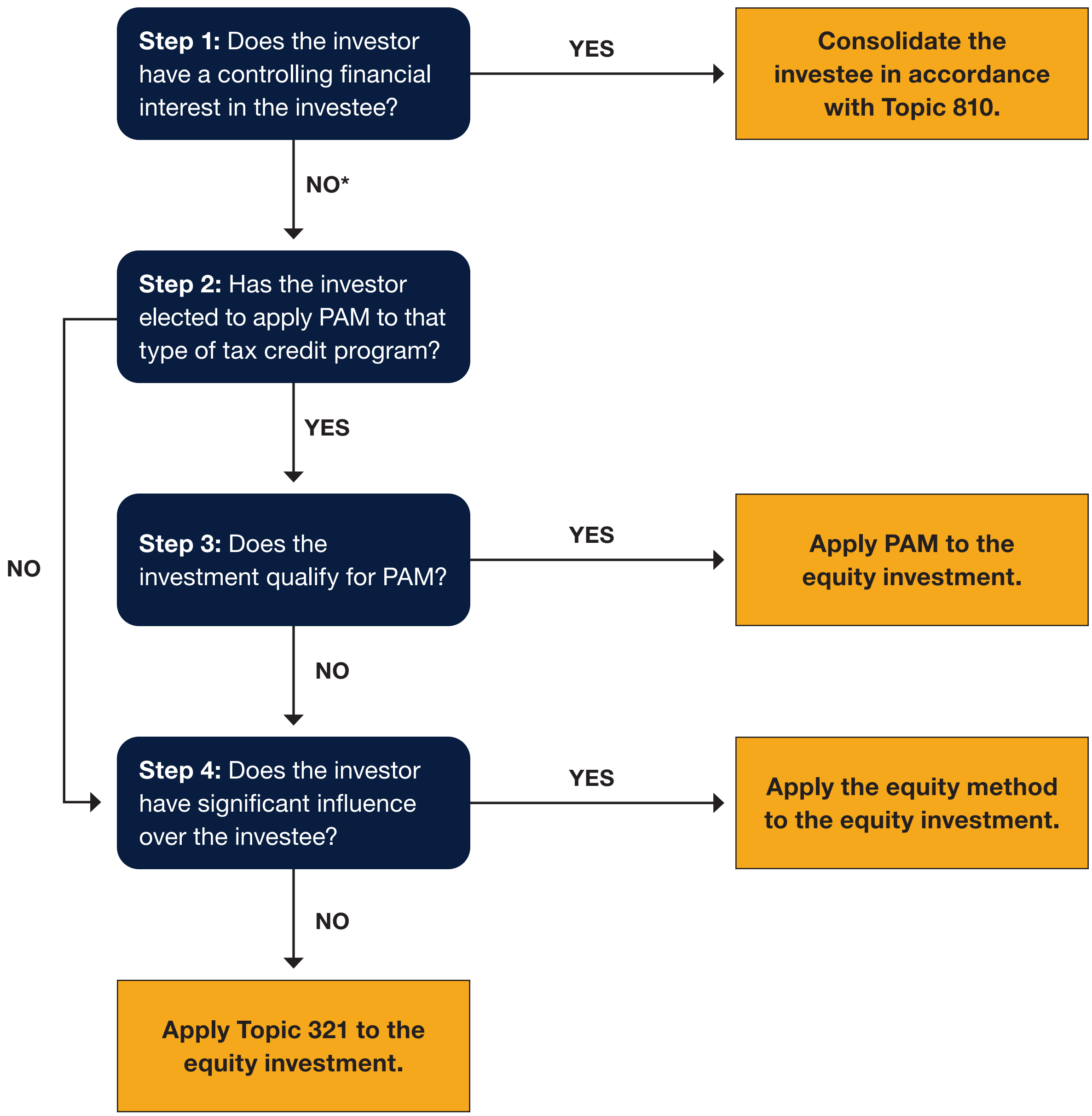
1 Topic 810, "Consolidation."

2 A more comprehensive discussion of the VIE model, including what constitutes a VIE and how to determine who its primary beneficiary is, is beyond the scope of this practice aid.

3 Topic 323, "Investments – Equity Method and Joint Ventures."

Flowchart: Determining how to account for equity investments in income tax credit projects

The following flowchart addresses the primary accounting questions for investors:



*If not required to consolidate the investee, an investor can elect the fair value option (FVO) for its investment under Topic 825, "Financial Instruments." Because many of the investments do not have readily determinable fair values, consideration of the FVO is not further explored.

CONSOLIDATION (STEP 1 OF FLOWCHART)

As with other equity investments, an investor with an equity investment in an income tax credit project must first determine if its involvement with the investee entity (or entities) provides it with a controlling financial interest, thereby requiring consolidation of the investee(s) in the investor's financial statements.

Most income tax credit structures are formed as limited partnerships or limited liability companies (LLCs). As such, determining whether the investor has a controlling financial interest in the investee typically involves an assessment of kick-out rights and participating rights held by the partners or members of the limited partnership or LLC.[4]

ASC 810-10-25-1A and ASC 810-10-25-2

Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. Consolidation is appropriate if a reporting entity has a controlling financial interest in a limited partnership and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest in a limited partnership is ownership of a majority of the limited partnership's kick-out rights through voting interests, but, in some circumstances, control does not rest with the majority owner.

Paragraph 810-10-15-10(a)(1)(iv) explains that, in some instances, the powers of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling shareholder or limited partner (referred to as noncontrolling rights). That paragraph also explains that, in paragraphs 810-10-25-2 through 25-14, the term noncontrolling shareholder refers to one or more noncontrolling shareholders and the terms limited partner and general partner refer to one or more limited or general partners. Paragraph 810-10-15-10(a)(1)(iv) explains that those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee's operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.

The usual condition for a controlling financial interest in a limited partnership is ownership of a majority of the limited partnership's kick-out rights – that is, the ability to unilaterally remove the general partner[5] – through voting interests (see ASC 810-10-25-1A). If a single equity investor with a majority of the partnership's kick-out rights can unilaterally remove the general partner without cause, the investor generally would be required to consolidate the partnership. In contrast, if an investor with a majority equity interest in a partnership cannot unilaterally remove the general partner – for example, because minority limited partners must also approve the general partner's removal or removal is limited to "termination for cause" situations – then the investor, despite its majority ownership interest, generally would not have a controlling financial interest (see ASC 810-10-25-2).

4 U.S. GAAP makes a distinction between LLCs that maintain separate capital accounts for each investor and those that do not. The former are treated like limited partnerships; the latter are not (see ASC 323-30-35-3). The remainder of this publication assumes that an LLC should be treated like a limited partnership under U.S. GAAP – that is, that separate capital accounts are maintained for each investor. As such, when the term "limited partnership" is used, it includes LLCs treated as limited partnerships.

5 Or, in the case of an LLC, the managing member.

While kick-out rights often are the focal point of a consolidation analysis for income tax credit structures, participating rights also should be considered. Participating rights are those that enable a limited partner to “participate in determining significant financial and operating decisions of the investee *that are made in the ordinary course of business*” (emphasis added) (see ASC 810-10-25-5 and 25-6). Participation rights enable the holder thereof to block the actions of a limited partner with a majority ownership interest or of the general partner such that agreement of the holder is needed for action to be taken. Participating rights of particular interest are those that affect the selection of management and the day-to-day operating and capital decisions of the investee.

The presence of participating rights alone does not give rise to a controlling financial interest. It could, however, affect whether an investor holding a majority of the kick-out rights concludes it has a controlling financial interest.

The structure of income tax credit structures and the rights granted to equity investors can vary considerably, even for those stemming from the same tax credit program; as a result, determining whether an investor has a controlling financial interest will require a careful examination of the purpose and design of the investee entity, the rights held by the various interest holders (including nonequity holders), and all other relevant facts and circumstances.

Importantly, an investor also must ensure the appropriate consolidation model is applied – that is, either the VIE model or the general consolidation (or VOE) model. While this aid does not cover each model in detail, investors should be aware that the assessment of control can differ between models. Additionally, if an investee is determined to be a VIE, then the investor will be required to provide the VIE-specific disclosures outlined in ASC 810-10-50.

If an investor determines it has a controlling financial interest in the tax credit structure, it applies Topic 810 to consolidate the entity into its consolidated financial statements. If consolidation is not required, the investor next considers whether PAM applies.

CROWE OBSERVATION:

Investors in NMTC structures should be mindful of whether their overall involvement with the community development entity (CDE) gives rise to a controlling financial interest. Often, the equity investor in the CDE is deemed to hold a controlling financial interest due to its influence over the significant activities of the CDE.

If an investor concludes it must consolidate the CDE, then application of PAM to the investor’s equity investment in the CDE is not permitted.

PROPORTIONAL AMORTIZATION METHOD (STEPS 2 AND 3 OF THE FLOWCHART)

Introduction

PAM is a specialized accounting model that provides preferential income statement presentation for investors' eligible equity investments in income tax credit projects. Under PAM, an investor amortizes the cost of its equity investment in proportion to the amount of income tax credits and other income-tax-related benefits received each reporting period.

The primary benefit of PAM is that the amortization of the investment's carrying amount is recorded within the investor's income tax expense (benefit) line item – the same line item in which the income tax credits and other income tax benefits are recorded – rather than as a component of pretax earnings.

Model	Balance sheet	Income statement
PAM	• Investment is initially recorded at cost. Certain capital commitments are required to be recorded upfront. • Investment is subsequently amortized in proportion to income tax credits and other income tax benefits received in the period.	• Amortization of investment is recorded in income tax expense (benefit) line item. • Receipt of income tax credits also are recorded in income tax expense (benefit) line item. • Non-tax-related investment income is recorded in pretax earnings.

CROWE OBSERVATION

Banks frequently invest in income tax credit structures, especially in those projects that provide regulatory credit under the *Community Reinvestment Act of 1977*. When PAM is applied to eligible equity investments, the favorable income statement presentation has the effect of lowering a company's efficiency ratio.[6]

6 The efficiency ratio is a measure of how well financial institutions manage their overhead expenses and often is measured as noninterest expense divided by the institution's revenue.

Scope

To apply PAM, two conditions must be met. First, the equity investment must be in a tax credit program to which the investor has elected to apply PAM. Second, the individual equity investment must meet all the scope criteria in ASC 323-740-25-1.

Condition 1: Policy election

ASC 323-740-25-4

The decision to apply the proportional amortization method is an accounting policy decision to be elected on a tax-credit-program-by-tax-credit-program basis that shall be applied consistently to all investments within an elected tax credit program that meet the conditions in paragraph 323-740-25-1 rather than a decision to be applied to individual investments that meet the conditions in paragraph 323-740-25-1.

To apply PAM, the equity investment must be in a tax credit program to which the investor has made an accounting policy election to apply PAM. If the investor is investing in a specific type of tax credit program for the first time, it must make an accounting policy election to apply PAM at the time of initial investment.

The policy election is made on a "tax-credit-program-by-tax-credit-program basis." Investors will need to apply judgment to determine the appropriate level at which to make this program-level policy election. For example, one investor might elect to apply PAM to any qualifying investment in a renewable energy tax credit project. Alternatively, another investor might decide to apply PAM to qualifying investments in wind tax credit projects but not to any investments in solar tax credit projects. Regardless of the level used to apply the "program-by-program" requirement, an investor should disclose and consistently apply its interpretation.

CROWE OBSERVATION

The election to apply (or not apply) PAM to equity investments in a specific program type is an accounting policy election. Consequently, if an investor desires to change its accounting policy at a future date, it must apply the guidance in Topic 250, "Accounting Changes and Error Corrections." To make a policy change, an investor must conclude the change is "preferable." Entities that are subject to Regulation S-X also might be required to file with the Securities and Exchange Commission (SEC) a "preferability letter" from the entity's independent accountant (see ASC 250-10-S99-4). If an investor changes its accounting policy election, the change should be applied retrospectively to all prior periods, unless it is impracticable.

For each program to which an investor elects to apply PAM, the investor is required to analyze each investment individually under the scope criteria to determine if PAM applies (see "Condition 2: Qualifying criteria"). Consequently, an investor might choose not to apply PAM to a program type if, for example, the total amount of its investments in a program type is not expected to be material and it does not want to incur the cost of analyzing each investment under the scope criteria.

Example 1: Program-by-program policy election

Entity A has equity investments in NMTC programs, HTC programs, RETC programs, and LIHTC programs. The entity elects to apply PAM to qualifying NMTC and LIHTC equity investments, but not to any of its HTC and RETC equity investments. Entity A has concluded HTC investments are not material; further, it does not believe many of its RETC investments would qualify for PAM.

Because Entity A elects not to apply PAM to its HTC and RETC investments, none of those investments would be assessed under the scope criteria in ASC 323-740-25-1 to determine if PAM applies. Rather, these investments would be accounted for either under the equity method or Topic 321, depending on Entity A's level of ownership. In contrast, each NMTC and LIHTC investment must be individually assessed for eligibility under the criteria in ASC 323-740-25-1. For each investment that qualifies, PAM must be applied to the investment; otherwise, the investment would be accounted for under either the equity method or Topic 321.

CROWE OBSERVATION

While an investor may elect PAM for any income tax credit program, this does not necessarily mean all investments in a tax credit program will meet the eligibility criteria in ASC 323-740-25-1. For example, certain investments in RETC programs might not meet the scope criteria because they could be priced such that the projected yield from the income tax credits and other income tax benefits would not be positive. Said differently, there could be instances in which not all equity investments within a tax credit program for which PAM has been elected meet the criteria to be accounted for under PAM.

Condition 2: Qualifying criteria

ASC 323-740-25-1

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met:

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

aa. The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project.

aaa. Substantially all of the projected benefits are from income tax credits and other income tax benefits (for example, tax benefits generated from the operating losses of the investment). Projected benefits include, but are not limited to, income tax credits, other income tax benefits, and other non-income-tax-related benefits, including refundable tax credits (that is, those tax credits not dependent upon an investor's income tax liability). Tax credits accounted for outside of the scope of Topic 740 (for example, refundable tax credits) shall be included in total projected benefits, but not in income tax credits and other income tax benefits when evaluating this condition. This condition shall be determined on a discounted basis using a discount rate that is consistent with the cash flow assumptions utilized by the investor for the purpose of making a decision to invest in the project.

b. The investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive.

c. The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.

Before an investor applies PAM to an equity investment, it must confirm the investment meets all the scope criteria outlined in ASC 323-740-25-1. This assessment is required for each investment that is part of a tax credit program for which the investor has elected to apply PAM (see "Condition 1: Policy election"). The scope criteria are designed to identify investments "made primarily for the purpose of receiving income tax credits and other income tax benefits" (ASC 323-740-05-1). Consequently, if any of the criteria are not met, the investor cannot apply PAM.

When assessing whether its equity investment meets the qualifying criteria, an investor should disregard other transactions between the investor and the investee entity – for example, the extension of a loan – if all three of the following conditions are satisfied:

ASC 323-740-25-1B

a. The [investor] is in the business of entering into those other transactions (for example, a financial institution that regularly extends loans to other projects).
b. The terms of those other transactions are consistent with the terms of arm's-length transactions.
c. The [investor] does not acquire the ability to exercise significant influence over the operating and financial policies of the underlying project as a result of those other transactions.

Additionally, the investor should assess the qualifying criteria using the facts and circumstances existing as of the date of the initial investment. Subsequent reassessment is not required unless one of the following events occurs:

- There is a change to the nature of the investment. For example, the investment is no longer in a flow-through entity for tax purposes.
- There is a change in the investor's relationship with the underlying project that could result in the investor no longer meeting the criteria in ASC 323-740-25-1. For example, the operating agreement changes such that the investor now has significant influence over the project.

Availability test

ASC 323-740-25-1

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met:

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

To apply PAM, the investor must conclude it is "probable" the income tax credits allocable to the investor will be available. For purposes of this assessment, "probable" means likely to occur. An investor assesses whether the availability of the tax credits is probable by considering factors such as whether the tax credit project's design satisfies the conditions to qualify for receipt of the tax credits. The investor might also consider the project operator's success rate in managing projects so that tax credits allocable to investors are received.

All factors that might affect the availability of the tax credits should be considered. In some cases, this assessment might require involvement of legal counsel.

Significant influence test

ASC 323-740-25-1 and 25-1A

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met: …

aa. The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project.

In determining whether an investor has the ability to exercise significant influence over the operating and financial policies of the underlying project, a reporting entity shall consider the indicators of significant influence in paragraphs 323-10-15-6 through 15-7. In considering the operating and financial policies of the underlying project, the investor shall consider the operations, financial decisions, and related objectives of the project as a whole.

In its basis for conclusions (BC) for ASU 2023-02, the FASB explains that an investor that can exercise significant influence "may have made the investment for reasons other than primarily for the receipt of income tax credits and other income tax benefits" (BC16 of ASU 2023-02). Therefore, an investor that can exercise significant influence over the operating and financial policies of the underlying tax credit project cannot apply PAM.

An investor possesses significant influence if it can influence the operating or financial policies of the underlying project. To determine whether it has significant influence over the underlying project, the investor applies the guidance in ASC 323-10-15-6 and 15-7. It does not, however, consider the quantitative ownership levels outlined in ASC 323-10-15-8 through 15-11 (for example, that a certain percentage ownership level presumably gives rise to significant influence). That is, for purposes of determining whether PAM can be applied, an investor focuses solely on qualitative indicators of influence.

The following table provides examples of operating and financial policies of tax credit projects that could indicate an investor has significant influence:

Operating policies	Financial policies
• Influence over the project manager, including kick-out rights and participating rights • Influence over the investee's operations or disposal of the project's assets	• Influence over the project's cash distribution policy • Influence over the composition of the project's capital structure or changes thereto • Approval rights over operating budget

The significant influence test is performed at the "underlying project" level. Practically, this means an investor in a multitiered tax credit investment structure (for example, an NMTC structure) should assess significant influence holistically throughout the entire investment structure rather than at the tier in which its investment resides, which could be different from where the assets generating the tax credits reside.

Substantially all test

ASC 323-740-25-1

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met: …

aaa. Substantially all of the projected benefits are from income tax credits and other income tax benefits (for example, tax benefits generated from the operating losses of the investment). Projected benefits include, but are not limited to, income tax credits, other income tax benefits, and other non-income-tax-related benefits, including refundable tax credits (that is, those tax credits not dependent upon an investor's income tax liability). Tax credits accounted for outside of the scope of Topic 740 (for example, refundable tax credits) shall be included in total projected benefits, but not in income tax credits and other income tax benefits when evaluating this condition. This condition shall be determined on a discounted basis using a discount rate that is consistent with the cash flow assumptions utilized by the investor for the purpose of making a decision to invest in the project.

To apply PAM, an investor must quantitatively conclude substantially all the projected benefits of its investment come from income tax credits and other income-tax-related benefits (for example, flow-through depreciation). While not defined in the guidance, "substantially all" is commonly interpreted to mean 90% or more. To perform the substantially all test, an investor compares the total of the income tax credits and the other income-tax-related benefits (the numerator) with the total of all projected benefits of the investment, including the amounts in the numerator (in total, the denominator).

$$\frac{\text{Income tax credits allocable to investor} + \text{Other income-tax-related benefits allocable to investor}}{\text{Non-income-tax-related benefits} + \text{Income tax credits allocable to investor} + \text{Other income-tax-related benefits}}$$

The substantially all test is performed on a discounted basis. That is, the amounts in both the numerator and the denominator are discounted to their present value before performing the assessment. While the guidance does not prescribe a specific discount rate to use – such as the project's internal rate of return, a risk-free rate, or some other rate – it does note an investor should use a discount rate consistent with the cash flow assumptions used by the investor when determining whether to invest in the project.

In identifying all income-tax-related benefits and non-income-tax-related benefits it expects to receive, an investor should consider the presence of the following benefits common to these types of investments:

Benefit	Income-tax-related?
Nonrefundable income tax credits	Yes. Income tax credits that are nonrefundable are among the primary income tax benefits of such investments. As such, they would be included in both the numerator and denominator of the calculation.
Nonrefundable, transferable income tax credits	It depends. No specific guidance in GAAP addresses the accounting for nonrefundable, transferable income tax credits. As such, diversity exists as to whether investors account for such credits under Topic 740. If the credits are accounted for within the scope of Topic 740, then they would be included in both the numerator and the denominator of the calculation. If the credits are accounted for outside the scope of Topic 740, then they would be included only in the denominator.
Refundable income tax credits	No. The FASB concluded refundable tax credits, while income tax-related, should not be included in the numerator because such investments are not subject to Topic 740. As such, these credits would be excluded from the numerator but included in the denominator of the calculation.
Taxable income (losses)	Yes. Items that drive the investor's portion of flow-through taxable income (losses) of the project, such as bonus depreciation, would be included in the numerator and the denominator.
Investment income	No. Investment income from the equity investment is not part of the numerator but should be included in the denominator.
Buyout option	No. The receipt of cash upon the sale or return of the investment is not part of the numerator or the denominator. See ASC 740-323-25-5.

Example 2A

- On Jan. 1, 202X, Investor makes an equity investment in a renewable energy project for an upfront payment of $6 million.
- The investment generates $5.8 million in eligible tax credits that are to be received by Investor in year 1.
- Investor determines an income tax rate of 24% should be used in its assessment of tax benefits, which comprises a 21% federal tax rate and a 3% state tax rate (net of any related federal benefit).
- Investor determines a 7% discount rate should be used to discount expected benefits.
- Book and tax depreciation are both recognized on a straight-line basis over 10 years.
- The periodic taxable loss recognized by the investee is assumed to be entirely attributable to depreciation expense.
- There is no reduction in the tax basis of the investment due to the receipt of the income tax credits.
- Investor plans to sell the project on Dec. 31, 203X for $300,000 upon exercise of a put/call option. Consistent with ASC 323-740-35-5, the expected cash flows from sale of the investment in year 10 is treated as a non-tax-related benefit.
- For simplicity, this example does not contemplate any deferred tax implications.

Investor prepares the following schedule of expected benefits arising from its equity investment in the renewable energy project:

	A	*B*	*C*	*D*	*E*	*F*
Year	**Investment**	**Tax credits**	**Call option**	**Taxable income/(losses)**	**Other tax benefits from tax depreciation**	**Tax credits and other benefits**
1	$6,000,000	$5,800,000	$ –	$(600,000)	$144,000	$5,944,000
2	–	–	–	(600,000)	144,000	144,000
3	–	–	–	(600,000)	144,000	144,000
4	–	–	–	(600,000)	144,000	144,000
5	–	–	–	(600,000)	144,000	144,000
6	–	–	–	(600,000)	144,000	144,000
7	–	–	–	(600,000)	144,000	144,000
8	–	–	–	(600,000)	144,000	144,000
9	–	–	–	(600,000)	144,000	144,000
10		–	–	(600,000)	144,000	144,000
10-call		–	300,000	300,000		
Total	**$6,000,000**	**$5,800,000**	**$300,000**	**$(5,700,000)**	**$1,440,000**	**$7,240,000**
Net present value			$280,374 G			***$6,775,776*** ***H***
Substantially all	96% H/(H+G)					

To determine whether its investment in the renewable energy project passes the substantially all test, Investor compares the net present value of income tax credits and other income-tax-related benefits ($6,775,776) to the total of all expected benefits from the investment ($7,056,150 = $6,775,776 + $280,374). Investor concludes 96% of the total expected benefits are tax related and, therefore, determines the substantially all test has been met.

Positive yield test

ASC 323-740-25-1

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met: …

b. ***The investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive.***

To apply PAM, an investor must quantitatively conclude its equity investment is projected to produce a positive yield – that is, a positive return on its investment – solely from the projected cash flows of the income tax credits and other income-tax-related benefits. Unlike the substantially all test, the positive yield test is performed on an undiscounted basis – that is, the sum of the projected undiscounted benefits from income tax credits and other income-tax-related benefits (the numerator) are compared to the amount of the entity's total capital investment (the denominator). A positive yield exists if the numerator exceeds the denominator.

$$\frac{\textbf{Income tax credits allocable to investor} + \textbf{other income-tax-related benefits}}{\textbf{Cost of investor's capital investment}}$$

Example 2B

Continuing with the facts and assumptions from Example 2A, Investor now assesses whether its investment passes the positive yield test. To do so, Investor compares the undiscounted total amount of income-tax-related benefits expected to be received from the investment ($7,240,000) to the amount of its initial investment ($6,000,000). Because the total amount of income-tax-related benefits exceeds its initial investment, Investor concludes the positive yield test is met.

	A	*B*	*C*	*D*	*E*	*F*
Year	**Investment**	**Tax credits**	**Call option**	**Taxable income/(losses)**	**Other tax benefits from tax depreciation**	**Tax credits and other benefits**
1	$6,000,000	$5,800,000	$ –	$(600,000)	$144,000	$5,944,000
2	–	–	–	(600,000)	144,000	144,000
3	–	–	–	(600,000)	144,000	144,000
4	–	–	–	(600,000)	144,000	144,000
5	–	–	–	(600,000)	144,000	144,000
6	–	–	–	(600,000)	144,000	144,000
7	–	–	–	(600,000)	144,000	144,000
8	–	–	–	(600,000)	144,000	144,000
9	–	–	–	(600,000)	144,000	144,000
10		–	–	(600,000)	144,000	144,000
10-call		–	300,000	300,000		
Total	**$6,000,000**	**$5,800,000**	**$300,000**	**$(5,700,000)**	**$1,440,000**	**$7,240,000**

Positive yield test F/A		1.207	**Criterion met**

Limited liability test

ASC 323-740-25-1

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met: …

c. **The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.**

To apply PAM to an equity investment, the investment must be in a limited liability entity – for example, in a limited partnership or a limited liability company.

Additionally, the investor must have limited liability. Specifically, the investor's liability must be limited to its capital investment. Consequently, if an entity acts as a general partner of an entity or its liability is not limited to the amount of its investment, PAM cannot be applied.

The structure of many income tax credit programs involves limited liability entities and limits tax equity investors' liability to the amount of their capital investment. As such, the application of this criterion often requires simple verification that such is the design of the investment. For more complex structures, an investor might need to consult with legal counsel.

Initial measurement

Under PAM, an investor's equity investment in a tax credit project initially is recorded at cost. If the investor is required to make delayed equity investments in the project, the amount of those future investments should be included in the investment's initial cost basis only if they are both unconditional and legally binding. If future equity contributions are contingent upon the occurrence of a future event, the investor should recognize the future investment as part of the investment's cost basis only when the occurrence of the future event becomes probable.

ASC 323-740-25-3

A liability shall be recognized for delayed equity contributions that are unconditional and legally binding. A liability also shall be recognized for equity contributions that are contingent upon a future event when that contingent event becomes probable. Topic 450 and paragraph 842-50-55-2 provide additional guidance on the accounting for delayed equity contributions.

Example 3

Entity A makes an initial $5 million investment in an LIHTC tax credit project. Concurrently with its initial investment, Entity A agrees to make an additional $5 million investment in the project the following year. Entity A concludes the additional investment is both unconditional and legally binding. Consequently, Entity A records the following entry to reflect its initial and future investment in the project:

Dr.	Tax credit investment – LIHTC		$10 million	
	Cr.	Cash		$5 million
	Cr.	Capital commitment – LIHTC		$5 million

CROWE OBSERVATION

Determining whether a delayed equity contribution should be capitalized as part of the initial carrying amount of an equity investment is important because it affects the amount of amortization to be recognized each reporting period. Consequently, entities applying PAM should establish adequate processes to ensure capital commitments are appropriately assessed and accounted for.

Subsequent measurement

ASC 323-740-35-2, 35-4, and 35-5

Under the proportional amortization method, the investor amortizes the initial cost of the investment in proportion to the income tax credits and other income tax benefits allocated to the investor. The amortization amount shall be calculated as follows:

a. The initial investment balance less any expected residual value of the investment, multiplied by
b. The percentage of actual income tax credits and other income tax benefits allocated to the investor in the current period divided by the total estimated income tax credits and other income tax benefits expected to be received by the investor over the life of the investment.

As a practical expedient, an investor is permitted to amortize the initial cost of the investment in proportion to only the income tax credits allocated to the investor if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result from applying the requirement in paragraph 323-740-35-2.

Any expected residual value of the investment shall be excluded from the proportional amortization calculation. Non-income-tax-related benefits received from operations of the limited liability entity shall be included in pre-tax earnings when realized or realizable. Gains or losses on the sale of the investment, if any, shall be included in pre-tax earnings at the time of sale.

Amortization of investment

Under PAM, an investor amortizes the initial cost of its investment in proportion to the income tax credits and other income-tax-related benefits allocated to the investor in the current reporting period. The amount of amortization recognized and reported in income tax expense (benefit) each reporting period is determined as follows:

$$\frac{\left(\text{Initial investment} - \text{Investor's expected residual value in the investment}\right) * \left(\text{Total income tax credits and other income-tax-related benefits received in the period}\right)}{\text{Total estimated income tax credits and other income tax benefits expected over the life of the investment}}$$

Example 2C: Continuing with the facts and assumptions from Example 2A

Column G in the following chart highlights the amount of amortization to be recognized during each reporting period.

	A	B	C	D	E	F	G	I
Year	Investment	Tax credits	Call option	Taxable income/ (losses)	Other tax benefits from tax depreciation	Tax credits and other benefits	Amoritization of investment	Book basis
1	$6,000,000	$5,800,000	$ –	$(600,000)	$144,000	$5,944,000	$4,679,669	1,320,331
2	–	–	–	(600,000)	144,000	144,000	113,370	1,206,961
3	–	–	–	(600,000)	144,000	144,000	113,370	1,093,591
4	–	–	–	(600,000)	144,000	144,000	113,370	980,221
5	–	–	–	(600,000)	144,000	144,000	113,370	866,851
6	–	–	–	(600,000)	144,000	144,000	113,370	753,481
7	–	–	–	(600,000)	144,000	144,000	113,370	640,110
8	–	–	–	(600,000)	144,000	144,000	113,370	526,740
9	–	–	–	(600,000)	144,000	144,000	113,370	413,370
10		–	–	(600,000)	144,000	144,000	113,370	300,000
10-call		–	300,000	300,000				–
Total	**$6,000,000**	**$5,800,000**	**$300,000**	**$(5,700,000)**	**$1,440,000**	**$7,240,000**	**$5,700,000**	

*(G) (Initial investment (A) – call option (C)) * total income tax benefits and other income tax benefits received during the year/total anticipated income tax credits and other income tax benefits over the life of the investment (F)*

As a practical expedient, an investor may elect to amortize the initial cost of the investment in proportion to only the income tax credits allocated to the investor, excluding other income-tax-related benefits, if the investor reasonably expects that doing so would produce a result substantially similar to the general amortization approach.

CROWE OBSERVATION

When an investor elects to amortize the initial cost of its investment in proportion to only the income tax credits, the investor should consider whether it needs to record a deferred tax asset or liability, especially if the period over which "other tax benefits" are received is longer than the period over which income tax credits are received.

Deferred taxes

ASC 323-740 does not address whether the investor should record deferred taxes for the temporary differences between the carrying amount of its equity investment and the tax basis. During the original development of PAM, members of the FASB's Emerging Issues Task Force observed that deferred taxes should not be recognized for the temporary difference between the book and tax basis of the investment and analogized to the existing guidance for purchased future tax benefits in ASC 740-10-25-52.

Practically, if deferred taxes are not recorded for the temporary difference, the investor will recognize a positive return (tax benefit) over the life of the investment in proportion to the investment amortization. In contrast, if deferred taxes are recorded for the temporary difference, the amount of income tax benefit recognized each reporting period is not aligned with, or in proportion to, the amortization of the equity investment. Consequently, the accounting result when deferred taxes are not recognized for this temporary difference seems more consistent with the underlying concept of PAM, which is to recognize the cost of the tax benefits in proportion to the tax credits and other tax benefits received.

ASC 323-740 is silent on whether deferred taxes should be recorded for the temporary difference between the equity investment's carrying amount and its tax basis, and diversity in practice exists. Investors that wish to recognize deferred taxes for this temporary difference should consult with their accounting adviser.

Investors that use the practical expedient described in ASC 323-740-35-4 should recognize deferred taxes of their investment because the entire cost of the investment is amortized over only the period in which tax credits are received. Deferred taxes recognized for the temporary difference will offset any other income tax benefits received after the amortization of the investment.

Accounting for the receipt of income tax credits and income-tax-related benefits

Under PAM, an investor accounts for the receipt of income tax credits in the period in which the tax credits are allocated for tax purposes.

ASC 740-10-25-45 and 25-46

An investment credit shall be reflected in the financial statements to the extent it has been used as an offset against income taxes otherwise currently payable or to the extent its benefit is recognizable under the provisions of this Topic.

While it shall be considered preferable for the allowable investment credit to be reflected in net income over the productive life of acquired property (the deferral method), treating the credit as a reduction of federal income taxes of the year in which the credit arises (the flow-through method) is also acceptable.

While Topic 740 outlines two methods to account for the investment credits, an equity investment accounted for under PAM must use the flow-through method; use of the deferral method is not permitted (see ASC 323-740-65-2(f)). Under this method, the investor immediately records receipt of the tax credit as a direct offset to its tax obligation through income tax expense (benefit).

Accounting for receipt of non-income-tax-related benefits

An investor accounts for the receipt of non-income-tax-related benefits as part of pretax earnings in the period in which they are received. For example, an entity that receives a cash distribution from the investee as a form of return on investment would record the benefit in pretax earnings – for example, as investment income – in the period received.

Similarly, if an equity investment generates refundable tax credits, an investor typically would account for the receipt of these credits as part of pretax earnings. As previously noted, refundable tax credits are outside the scope of Topic 740. Frequently, an investor will account for refundable tax credits under a "government grant"-type model, such as International Accounting Standard 20 or Subtopic 958-605.

Changes in tax rates

An investor's tax rate is an important input in determining whether an equity investment qualifies for application of PAM. For example, the tax rate is used to determine the amount of expected income-tax-related benefits, such as losses arising from depreciation expense. Consequently, a change in tax rates could impact the expected amount of total tax credits and other income-tax-related benefits to be received from the investment.

CROWE OBSERVATION

The *Tax Cuts and Jobs Act of 2017* (TCJA) lowered the corporate federal tax rate from 35% to 21%. Depending on the time of initial investment in relation to the enactment of the TCJA, the 14% decrease in the rate could have resulted in a significant decrease in the amount of income-tax-related benefits received.

An investor that experiences a change in tax rates should determine how the change affects the amortization of its equity investments accounted for under PAM.

Impairment

An equity investment accounted for under PAM is tested for impairment when events or circumstances indicate it is more likely than not that the carrying amount of the investment will not be realized. For example, the failure of an investee's management to adhere to the guidelines of a tax credit program could result in the loss of tax credits or other income-tax-related benefits.

If an entity concludes it is more likely than not that the carrying amount of its investment will not be realized, the amount of impairment recorded is the amount by which the carrying amount of the investment exceeds its fair value. The fair value of an investment should be determined in accordance with Topic 820, "Fair Value Measurement."

Disposal of investment

Many investments in tax credit projects provide a mechanism by which either the investor or investee can terminate the investment once substantially all of the income tax credits and other income-tax-related benefits have been received by the investor. For example, the investee entity might hold a call option whereby it can repurchase the equity investment upon meeting certain predefined conditions.

Gains (losses) recognized by an investor on the disposal of an equity investment should be recognized in pretax earnings at the time of disposal.

Disclosure

ASC 323-740-50 prescribes specific disclosure requirements for all investments in tax credit programs to which the investor has elected to apply PAM, regardless of whether an individual investment meets the scope criteria in ASC 323-740-25-1. Said differently, what drives whether an investment is subject to the disclosure requirements is whether it is in a program to which the investor has elected to apply PAM, not whether an investment meets the qualifying criteria. The disclosure requirements apply to each reporting period, including interim reports.

Under ASC 323-740-50-1, an investor must disclose information to enable users of the financial statements to understand both the nature of its investments and the effect of the investments on its financial position and results of operations.

To achieve those objectives, ASC 323-740-50-21A provides specific disclosure requirements.

ASC 323-740-50-21A

a. The amount of income tax credits and other income tax benefits recognized during the period, including the line item in the statement of operations and statement of cash flows in which it has been recognized.
b. The amount of investments and the line item in which the investments are recognized in the statement of financial position.
c. For investments accounted for using the proportional amortization method, the amount of investment amortization recognized as a component of income tax expense (benefit).
d. For investments accounted for using the proportional amortization method, the amount of non-income-tax-related activity and other returns received that is recognized outside of income tax expense (benefit) and the line item in the statement of operations and statement of cash flows in which it has been recognized.
e. For investments accounted for using the proportional amortization method, significant modifications or events that resulted in a change in the nature of the investment or a change in the relationship with the underlying project.

While not explicitly required, ASC 323-740-50-2 states an investor might disclose the following additional information about investments in a tax credit program for which it has elected to apply the proportional amortization method:

ASC 323-740-50-2

d. For investments accounted for using the equity method, the amount of investment income or loss included in pretax income
e. Any commitments or contingent commitments (for example, guarantees or commitments to provide additional capital contributions), including the amount of delayed equity contributions and the year or years in which 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 income tax credits or other circumstances. For example, in a qualified affordable housing project investment, those impairment losses may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions, or other issues.

Comprehensive examples

This section provides two comprehensive examples of how an investor would account for an equity investment under PAM. In each example, it is assumed the investor has elected to apply PAM to the specific program type and that the individual investment meets the qualifying criteria.

Example 4: LIHTC (ASC 323-740-55-3 through 55-5)

The following are the terms for this Example.

Date of investment	January 1, 20X1
Purchase Price of Investment	$100,000

This Example has the following assumptions:

a. All cash flows (except initial investment) occur at the end of each year.

b. Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 27.5 year life (the same method is used for simplicity).

c. The investor made a $100,000 investment for a 5 percent limited partnership interest in the project at the beginning of the first year of eligibility for the tax credit.

d. The partnership finances the project cost of $4,000,000 with 50 percent equity and 50 percent debt.

e. The annual tax credit allocation (equal to 4 percent of the project's original cost) will be received for a period of 10 years.

f. The investor's tax rate is 40 percent.

g. The project will operate with break-even pretax cash flows including debt service during the first 15 years of operations.

h. The project's taxable loss will be equal to depreciation expense. The cumulative book loss (and thus the cumulative depreciation expense) recognized by the investor is limited to the $100,000 investment. …

j. It is assumed that all requirements are met to retain allocable tax credits so there will be no recapture of tax credits.

k. The investor expects that the estimated residual value of the investment will be zero.

l. All of the conditions described in paragraph 323-740-25-1 are met to apply the proportional amortization method, and the entity has elected to use the proportional amortization method to account for its tax equity investments in this tax credit program in accordance with paragraph 323-740-25-4.

An analysis of the proportional amortization method follows.

	A	*B*	*C*	*D*	*E*	*F*	*G*
Year	**Net investment (1)**	**Amoritization of investment (2)**	**Tax credits (3)**	**Net losses/tax depreciation (4)**	**Other tax benefits from tax depreciation (5)**	**Tax credits and other benefits (6)**	**Tax credits and other tax benefits, net of amoritization (7)**
1	$90,909	$9,091	$8,000	$7,273	$2,909	$10,909	$1,818
2	81,818	9,091	8,000	7,273	2,909	10,909	1,818
3	72,727	9,091	8,000	7,273	2,909	10,909	1,818
4	63,636	9,091	8,000	7,273	2,909	10,909	1,818
5	54,545	9,091	8,000	7,273	2,909	10,909	1,818
6	45,454	9,091	8,000	7,273	2,909	10,909	1,818
7	36,363	9,091	8,000	7,273	2,909	10,909	1,818
8	27,272	9,091	8,000	7,273	2,909	10,909	1,818
9	18,181	9,091	8,000	7,273	2,909	10,909	1,818
10	9,090	9,091	8,000	7,273	2,909	10,909	1,818
11	6,666	2,424	–	7,273	2,909	2,909	485
12	4,242	2,424	–	7,273	2,909	2,909	485
13	1,818	2,424	–	7,273	2,909	2,909	485
14	–	1,818	–	5,451	2,183	2,183	365
15	–	–	–	–	–	–	–
Total		**$100,000**	**$80,000**	**$100,000**	**$40,000**	**$120,000**	**$20,000**

(1) End-of-year investment for a 5% limited liability interest in the project net of amoritization in Column (2).
(2) Initial investment of $100,000 x (total tax benefits received during the year in Column (6) / total anticipated tax benefits over the life of the investment of $120,000).
(3) 4 percent tax credit on $200,000 tax basis of underlying assets.
(4) Depreciation (on $200,000 tax basis of the underlying assets) using the straight-line method over 27.5 years up the amount of the initial investment of $100,000.
(5) Column (4) x 40% tax rate.
(6) Column (3) + Column (5).
(7) Column (6) – Column (2).

Example 5: Renewable energy tax credit

Entity B makes an investment in a renewable energy tax credit structure. The facts and circumstances surrounding the entity and its investment are as follows:

- On Jan. 1, 202X, Entity B invests in a renewable energy project for a lump sum payment of $6 million with $5.8 million in eligible tax credits available in year 1.
- The income tax rate of 24% assumes 21% federal and 3% state (net of federal benefit).
- Discount rate is determined to be 7%.
- Book and tax depreciation are both straight-line over 10 years; there is no accelerated or bonus depreciation for tax.
- The taxable loss is primarily attributable to depreciation expense.
- There is no reduction in tax basis for the income tax credits.
- Entity B plans to sell the project on Dec. 31, 203X for $300,000 upon exercise of put/call option.
- The example does not contemplate any deferred tax implications.

	A	*B*	*C*	*D*	*E*	*F*	*G*	*G*	*I*
Year	**Investment**	**Income tax credits**	**Put/call option**	**Taxable income/ (loss)**	**Other income tax benefits from tax loss**	**Tax credits and other income tax benefits**	**Amortization of investment**	**Income tax credits and other income tax benefits, net of amortization**	**Book basis**
1	$6,000,000	$5,800,000	$ –	$(600,000)	$144,000	$5,944,000	$4,679,669	$1,264,331	$1,320,331
2				(600,000)	144,000	144,000	113,370	30,630	1,206,961
3				(600,000)	144,000	144,000	113,370	30,630	1,093,591
4				(600,000)	144,000	144,000	113,370	30,630	980,221
5				(600,000)	144,000	144,000	113,370	30,630	866,851
6				(600,000)	144,000	144,000	113,370	30,630	753,481
7				(600,000)	144,000	144,000	113,370	30,630	640,110
8				(600,000)	144,000	144,000	113,370	30,630	526,740
9				(600,000)	144,000	144,000	113,370	30,630	413,370
10				(600,000)	144,000	144,000	113,370	30,630	300,000
10-call			300,000	300,000					–
Total	**$6,000,000**	**$5,800,000**	**$300,000**	**$(5,700,000)**	**$1,440,000**	**$7,240,000**	**$5,700,000**	**$1,540,000**	

DOES THE REPORTING ENTITY HAVE SIGNIFICANT INFLUENCE OVER THE INVESTEE (STEP 4 OF FLOWCHART)?

Model	Balance sheet	Income statement	Cash flow statement
Equity method (Topic 323)	• Investment is initially recorded at cost. • Investment is subsequently adjusted based on investor's proportionate share of investee's income (or loss) in the period.	• Adjustment to investment carrying amount is recorded in pretax earnings (above the line). • Receipt of income tax credits is recorded in income tax expense (benefit) line item.	• The cash flow impact of the equity investment is recorded through investing cash flows.

Significant influence

If an equity investment does not qualify for PAM or the investment is in a program to which the investor has elected not to apply PAM, the investor must next evaluate if it has significant influence over the investee.

Assessing significant influence under the equity method

- Consider the guidance in ASC 323-10-15-6 through 15-11 (both qualitative and quantitative considerations).
- For limited partnerships, an ownership interest greater than 3% to 5% presumably gives rise to significant influence. For all other entities, an ownership interest of 20% or more presumably gives rise to significant influence (see ASC 323-30-S99-1).

As noted in the previous section "Consolidation (step 1 of flowchart)," tax credit structures typically are set up as either limited partnerships or LLCs. The business structure of the investee is important because the evaluation of significant influence differs between corporations and limited partnerships. Because most tax credit structures are set up as limited partnerships or LLCs, this practice aid focuses solely on the assessment of significant influence for limited partnership and LLC entities.

Under U.S. GAAP, an investor generally is presumed to have significant influence over a limited partnership when its investment is considered "more than minor" (see ASC 970-323-25-6). In practice, this usually is interpreted to mean that an investor with a greater than 3% to 5% equity interest would be deemed to have significant influence over the investee (see ASC 323-30-S99-1). Consequently, for investments over this threshold, application of the equity method generally is appropriate. On the other hand, for investments under this threshold, the investor is presumed to not have significant influence and, therefore, application of the equity method typically would not be appropriate.

ASC 323-30-S99-1

The following is the text of SEC Staff Announcement: Accounting for Limited Partnership Investments.

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.

Equity method – recognition and measurement

Under the equity method, an investor initially measures its investment at cost (see ASC 323-10-30-2). All costs associated with the acquisition of the investment (for example, transaction costs) are included.

In some tax credit structures, investors are not required to contribute all committed capital at once but can be called on in the future to make additional capital contributions. Under the equity method, the initial investment recorded should be the amount of capital contributed only (that is, not the amount of total capital committed), unless recognition of the entire commitment is required under other authoritative guidance (for example, recognition of guarantees under Topic 460, "Guarantees"). Any unfunded commitments would need to be evaluated under the guidance of Topic 440, "Commitments," for possible recognition or disclosure.

CROWE OBSERVATION

Unlike for investments accounted for under PAM, an investor applying the equity method does not record unconditional and legally binding capital commitments as part of its initial investment. Rather, the carrying amount of the investment is adjusted only when the investor makes the actual incremental capital investment.

Subsequently, the investor adjusts the carrying amount of its equity investment each period for its share of the investee's earnings, additional contributions made, dividends or other distributions received, and any impairment losses recognized (see ASC 323-10-35-4). Often, determining an investor's share of earnings in tax credit structures can be more complex than simply multiplying the investor's ownership percentage by the investee's earnings. For example, the partnership agreement might allocate earnings, cash flows, and tax attributes differently. In such cases, the investor will need to adopt an allocation method that reflects its "share of the earnings or losses of an investee in the periods for which they are reported by the investee" (ASC 323-10-35-4).

Hypothetical liquidation at book value (HLBV) method

Often, when the earnings or losses of the investee are allocated on an other-than-pro rata basis, an investor will apply the HLBV method. The HLBV method for allocating partnership earnings and losses was included in a proposed American Institute of Certified Public Accountants Statement of Position, "Accounting for Investors' Interests in Unconsolidated Real Estate Investments," in 2000 but was never codified in GAAP. While the Statement of Position was never finalized and is not authoritative, the HLBV method often is used in practice for investments in renewable energy tax credit structures accounted for under the equity method.

HLBV uses a balance sheet approach to capture the change in the investor's claim on the investee's net assets as reported under GAAP. Under the HLBV method, changes in the investor's claim on the investee's net assets that would result from the period-end hypothetical liquidation of the investee at book value form the basis for determining the investor's share of the investee's earnings or losses.

Under the HLBV method, the investor recognizes its share of an investee's earnings or losses using the following formula:

$$\text{Period end claim on net assets as reported under GAAP} + \text{Distribution received during the period} - \text{Contributions made during the period} - \text{Prior-period claim on net assets as reported under GAAP}$$

Given the complexities that can arise in its application, a comprehensive discussion of the HLBV method is beyond the scope of this publication.

Impairment considerations

An equity method investment is tested for impairment when events or circumstances indicate it is more likely than not the carrying amount of the investment will not be realized. Before an impairment loss is recognized, the investor must conclude the decline in value is other than temporary. Evidence of an other-than-temporary decline in value includes concluding the investor cannot recover the carrying amount of the investment or the investee is unable to sustain earnings that would justify the carrying amount of the investment. If the decline is determined to be other than temporary, the investor records a loss equal to the amount by which the carrying amount of the investment exceeds its fair value. Fair value should be determined in accordance with Topic 820, "Fair Value Measurement."

CROWE OBSERVATION

Prior to the issuance of ASU 2023-02, ASC 323-740 included an example of the application of the equity method to an LIHTC investment. In the example, impairment was measured using undiscounted cash flows. ASU 2023-02 removed that example from ASC 323-740. Consequently, all equity investments in tax credit structures that are accounted for under the equity method should now apply the impairment guidance in ASC 323-10-35-32.

TOPIC 321 (STEP 4 OF THE FLOWCHART)

Model	Balance sheet	Income statement	Cash flow statement
Topic 321 – alternative measurement method	• Equity investment is initially recorded at cost. • The investment is subsequently measured at cost, less any impairment. • If an observable price change occurs, the investment is adjusted to its fair value.	• Receipt of income tax credits is presented in income tax expense (benefit) line item. • Impairment is recognized in pretax earnings. • Adjustments to fair value are recognized in pretax earnings.	• The cash flow impact of the equity investment is recorded through investing cash flows.

Topic 321 applies to an equity investment in a tax credit structure when the investor concludes its investment a) does not represent a controlling financial interest, b) is not eligible for PAM or the investor has elected not to apply PAM, and c) does not provide the investor with significant influence.

Practically speaking, Topic 321 applies when an equity investment is so minor that the investor has "virtually no influence over [the investee's] operating and financial policies" (see ASC 970-323-25-6). In practice, an ownership percentage threshold of below 3% to 5% commonly is used to determine that an interest in another entity is minor.

Understanding Topic 321

Topic 321, Master Glossary excerpt

ASC 321-10-35-1
Except as provided in paragraph 321-10-35-2, investments in equity securities shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for equity securities shall be included in earnings.

Readily Determinable Fair Value
An equity security has a readily determinable fair value if it meets any of the following conditions:

a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.
b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
c. The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

Under Topic 321, the investor's equity investment is initially recorded at cost. If the investment has a readily determinable fair value, then it is subsequently measured at fair value. However, equity investments in tax credit structures often do not have a readily determinable fair value. Consequently, investors typically account for such investments under the "alternative measurement method" in Topic 321 (see ASC 321-10-35-2).

ASC 321-10-35-2

An entity may elect to measure an equity security without a readily determinable fair value that does not qualify for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59 at its cost minus impairment, if any. If an entity identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, it shall measure the equity security at fair value as of the date that the observable transaction occurred. An election to measure an equity security in accordance with this paragraph shall be made for each investment separately. Once an entity elects to measure an equity security in accordance with this paragraph, the entity shall continue to apply the measurement guidance in this paragraph until the investment does not qualify to be measured in accordance with this paragraph (for example, if the investment has a readily determinable fair value or becomes eligible for the practical expedient to estimate fair value in accordance with paragraph 820-10-35-59). The entity shall reassess at each reporting period whether the equity investment without a readily determinable fair value qualifies to be measured in accordance with this paragraph. If an entity measures an equity security in accordance with this paragraph (and the security continues to qualify for measurement in accordance with this paragraph), the entity may subsequently elect to measure the equity security at fair value. If an entity subsequently elects to measure an equity security at fair value, the entity shall measure all identical or similar investments of the same issuer, including future purchases of identical or similar investments of the same issuer, at fair value. The election to measure those securities at fair value shall be irrevocable. Any resulting gains or losses on the securities for which that election is made shall be recorded in earnings at the time of the election.

The alternative measurement method

Under the alternative measurement method, an investor accounts for its investment at cost less impairment. Additionally, if the investor identifies observable price changes in orderly transactions for the identical or a similar investment of the same issuer, it must measure the equity security at fair value as of the date that the observable transaction occurred. Any adjustment to the investment's carrying amount – for example, due to impairment – is recognized through pretax earnings.

CROWE OBSERVATION

Under Topic 321, an investor must adjust the carrying amount of its investment to fair value if it identifies "observable price changes in orderly transactions for the identical or a similar investment of the same issuer." An example of a transaction that could be a potential source for observable prices is a purchase or sale of the same equity instrument in a secondary market transaction.

An investor must evaluate its equity investment for impairment each reporting period. Topic 321 requires an investor to assess if the investment is impaired (that is, the fair value of the investment is lower than its carrying amount) based on a qualitative assessment. Potential indicators of impairment the investor should consider include the following:

ASC 321-10-35-3

a. A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee
b. A significant adverse change in the regulatory, economic, or technological environment of the investee
c. A significant adverse change in the general market condition of either the geographical area or industry in which the investee operates
d. A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
e. Factors that raise significant concerns about the investee's ability to continue as a going concern, such as a negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants

If the investor concludes its investment is impaired, the investor must recognize an impairment loss in pretax earnings equal to the amount by which the investment's carrying amount exceeds its fair value.

Accounting for income tax credits and other income-tax-related benefits received under Topic 321

The receipt of an income tax credit or other income-tax-related benefits are reflected as a component of income tax expense (benefit) in the period received.

Accounting for non-income-tax-related benefits under Topic 321

An investor accounts for the receipt of non-income-tax-related benefits – for example, investment income – as a component of pretax earnings.

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