FASB issues ASU

Simplified investor accounting for tax equity investments

March 29, 2023

Investors in certain tax equity investments may elect the proportional amortization method by tax credit program.

Source and applicability

- Final ASU, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method
- Equity investors in income tax credit structures through limited liability entities (e.g. partnerships, LLCs) that are flow-through entities for tax purposes (i.e. tax equity investments)

Fast facts, impacts, actions

On March 29, 2023, the FASB issued ASU 2023-02, which expands the population of investments for which an investor may elect to apply the proportional amortization method (PAM). Expanding the availability of the PAM may simplify an investor's accounting for a more diverse population of tax equity investments and provide users of the financial statements with a better understanding of the related returns.

PAM accounting has been available for qualifying investments in Qualified Affordable Housing Projects (e.g. low income housing tax credit or LIHTC investments) as an alternative to either the cost or equity method of accounting since 2014. Given the economic similarities between LIHTC investments and other tax equity investments, stakeholders requested the FASB consider expanding the availability of the PAM.

Under the ASU, an investor in a tax equity investment may elect the PAM for qualifying investments on a tax credit program-by-program basis. To qualify for the PAM, an investment must meet the criteria previously applicable only to LIHTC investments, as clarified by the ASU. Disclosures are required on an interim and annual basis for tax equity investments in tax credit programs for which the PAM is elected, regardless of whether the PAM is applied.

The ASU also eliminates certain guidance previously provided for LIHTC investments related to the cost method, equity method impairment and delayed equity contributions.

The expansion of the PAM is effective for public business entities for annual periods beginning after **December 15, 2023,** and one year later for all others, with early adoption permitted. Investors in tax equity investments should assess whether to elect the PAM for a tax credit program and whether to early adopt the ASU. See Effective dates and transition.

Overview of PAM

Under the PAM, an investor amortizes the cost of its investment through income tax expense or benefit as an offset to the nonrefundable income tax credits and other income tax benefits (e.g. tax depreciation) that it receives from the project entity. Periodic amortization is calculated as the investor's share of income tax benefits generated in the period divided by the total income tax benefits the investor expects to receive over the life of the investment.

Overview of ASU

The main provisions of the ASU:

- **Expand the population of qualifying investments to which the PAM may be applied.** Instead of being limited to qualifying LIHTC investments, the PAM may be applied to all tax equity investments that meet the qualifying criteria (such as certain investments in renewable energy projects that generate tax credits), provided the investor has elected the PAM for the tax credit program from which an investment generates credits (see below).
- **Clarify the qualifying investment criteria.** As discussed further below, the clarified criteria:
  - focus on 'income' tax credits and other 'income' tax benefits;
  - require performance of the significant influence assessment in relation to the operations of the underlying project instead of the limited liability entity; and
  - provide guidance on how to determine whether substantially all of a tax equity investment's projected benefits are from income tax credits and other income tax benefits.
- **Provide for election of the PAM on a tax credit program-by-program basis.** An investor may elect to apply the PAM to qualifying tax equity investments that generate tax credits from one tax credit program and elect not to apply the PAM to investments that generate tax credits from a different tax credit program.
- **Require use of the flow-through method of accounting to account for the related tax credit when the PAM is applied even if the investor has generally elected the deferral method of accounting for its investment tax credits.** See section 2.2 of KPMG Handbook, Diverse accounting for energy tax credits, for guidance on the flow-through and deferral methods.
- **Require disclosures on an interim and annual basis for tax equity investments in tax credit programs for which the PAM is elected.** As discussed further below, certain disclosures are required regardless of whether the PAM is applied.

The ASU also includes other amendments to the guidance in Subtopic 323-740 on applying the cost method and equity method to tax equity investments when the PAM is not applied and accounting for delayed equity contributions. Additional information about these amendments and the effective date and transition provisions for all amendments are discussed below.

Clarifications to the qualifying investment criteria

The PAM may be applied only to 'qualifying' tax equity investments. Paragraph 323-740-25-1 includes the criteria that must be met for an investment to qualify for use of the PAM. The following table summarizes those criteria (as amended) and the related clarifications in the ASU.

<table>
<tr><th>Criteria in paragraph 323-740-25-1</th><th>Clarifications</th></tr>
<tr><td>It is probable that the income tax credits allocable to the investor will be available.</td><td rowspan="2">Focus on ‘income’ tax credits and ‘income’ tax benefits instead of tax credits and benefits, in general.</td></tr>
<tr><td>The investor’s projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive.</td></tr>
<tr><td>The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project.</td><td>Indicate that the assessment of significant influence is made in relation to the operations of the underlying project instead of the limited liability entity. This clarifies application of the criterion to multi-tier structures.[1]</td></tr>
<tr><td>Substantially all[2] of the projected benefits are from income tax credits and other income tax benefits (e.g. tax benefits generated from the operating losses of the investment) as opposed to non-income-tax benefits.</td><td>Focus on ‘income’ tax credits and ‘income’ tax benefits instead of tax credits and benefits, in general.

Perform the test on a discounted basis using a discount rate consistent with the risks reflected in the investor’s cash flow assumptions when deciding to invest in the tax equity investment.

Include in the denominator of the test (i.e. projected benefits) all income tax credits, other income tax benefits, non-income-tax benefits (including refundable tax credits) and any other projected benefits.

Exclude from the numerator of the test refundable tax credits (i.e. they are not considered income tax credits or other income tax benefits). This is consistent with the presentation of refundable tax credits in pre-tax income because their realization does not rely on the generation of taxable income (paragraph 9.167c of KPMG Handbook, Accounting for income taxes).</td></tr>
<tr><td>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.</td><td>N/A.</td></tr>
<tr><td colspan="2">Notes:
1. A corresponding clarification was made to the circumstances under which an investor that has elected the PAM is required to reassess the criteria. As clarified, such reassessment is required upon a change in the nature of the investment or a change in the relationship with the underlying project (instead of the limited liability entity).
2. An EITF Issue led to the issuance of the ASU. During its deliberations, the EITF discussed whether to make changes to the ‘substantially all’ threshold, which in practice has generally been interpreted as 90%. No changes were made to the threshold as a result of those discussions.</td></tr>
</table>

> Performing the 'substantially all' test on a discounted basis makes it possible for some investments (e.g. certain renewable energy investments) to qualify for the PAM that would not have if the evaluation were performed on an undiscounted basis, and better reflects the economic weighting of income tax versus non-income-tax benefits.

Other amendments to Subtopic 323-740

Other amendments to Subtopic 323-740 in the ASU include:

- removing the guidance indicating that it may be appropriate to apply the cost method to an LIHTC investment;
- removing the example related to the impairment of an LIHTC investment accounted for using the equity method; and
- making the delayed equity contributions guidance applicable only when the PAM is applied to a tax equity investment.

Disclosures

The ASU includes a disclosure objective and disclosure requirements that apply to all tax equity investments in tax credit programs for which the PAM is elected (regardless of whether the investment meets the qualifying criteria and the PAM is actually applied).

The disclosure objective is to provide information on an interim and annual basis that enables financial statement users to understand, for tax equity investments in tax credit programs for which the PAM is elected:

- the nature of the investor's tax equity investments; and
- the effect of the recognition and measurement of the investor's tax equity investments and the related income tax credits and other income tax benefits on the investor's balance sheet and income statement.

To satisfy these objectives, the ASU requires the following disclosures on an interim and annual basis for tax equity investments within tax credit programs for which the PAM is elected.

Required disclosures when the PAM is elected, regardless of whether it is applied
• The amount of income tax credits and other income tax benefits recognized during the period, including the line item in the income statement and statement of cash flows in which they have been recognized. • The balance of the investments and the line item in which the investments are recognized in the balance sheet.
Required disclosures when the PAM is both elected and applied
• The amount of investment amortization recognized as a component of income tax expense (benefit). • The amount of non-income-tax-related activity and other returns received that are recognized outside of income tax expense (benefit) and the line item in the income statement and statement of cash flows in which they have been recognized. • 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.

The ASU also includes additional disclosures an investor may consider providing to satisfy the disclosure objectives.

Effective dates and transition

	Public business entities	All other entities
Annual and interim periods – Fiscal years beginning after	December 15, 2023	December 15, 2024
Early adoption permitted?	Yes	Yes

Entities may early adopt the ASU in any interim period, with adjustments to opening balances as of the beginning of the fiscal year that includes the interim period. The disclosures required upon transition are consistent with those otherwise required for accounting changes under Topic 250 (accounting changes and error corrections).

Transition for expansion of the PAM and PAM-related clarifications

An investor chooses between the modified retrospective and retrospective transition methods when adopting the changes related to the expansion of the PAM (and PAM-related clarifications, including the revisions to the qualification criteria and the requirement to use the flow-through method). The following table summarizes the provisions of each transition method.

<table>
<tr><th>Transition provision</th><th>Modified retrospective</th><th>Retrospective</th></tr>
<tr><td>Apply the PAM to all qualifying tax equity investments expected to generate income tax credits or other income tax benefits as of…</td><td>the beginning of the fiscal year of adoption (i.e. application date).</td><td>the beginning of the earliest period presented (i.e. the application date).</td></tr>
<tr><td rowspan="2">Determine whether the investment qualifies for use of the PAM as of the date the investor made the investment (i.e. the investment date) considering the effect of any modifications and using…</td><td colspan="2">the sum of the following as the numerator in the ‘substantially all’ test:
• the actual benefits received as of the application date; and
• an estimate of the benefits expected to be received after the application date.</td></tr>
<tr><td colspan="2">actual equity contributions made and expected remaining equity contributions as of the application date.</td></tr>
<tr><td>Record a cumulative effect adjustment in retained earnings calculated as…</td><td colspan="2">the difference between the carrying amounts of the investment as of the application date based on:
• the previous accounting; and
• the new accounting, as if it had been applied since the investment date.</td></tr>
</table>

The transition method elected must be consistently applied to all affected investments.

Transition for other changes

The following table summarizes the transition methods an investor chooses between for the other changes in the ASU. A different transition method may be adopted for each type of change, but all of the changes resulting from each type of change must be accounted for using the same transition method.

Other changes	Transition method options	
Removal of the cost method guidance	Investor's general transition method[1]	Prospective application of Topic 321 to the investment's carrying amount on the adoption date[2]
Removal of the equity method impairment guidance	Investor's general transition method[1]	Prospective application of Topic 323 to the investment's carrying amount on the adoption date[2]
Limitation of the delayed equity contributions guidance to only tax equity investments to which the PAM is applied	Investor's general transition method[1]	Prospective application of other applicable guidance on the adoption date[2]
Notes: 1. The method elected to account for the expansion of the PAM and PAM-related clarifications. 2. The beginning of the fiscal year of adoption.		

The prospective application option may result in an adjustment to the carrying amount of an LIHTC investment on the adoption date. This adjustment may affect the current-period income statement, the balance sheet or both. The following are examples of adjustments that may be necessary when applying the prospective application option.

- When adopting the removal of the equity method impairment guidance, an investor determines whether an impairment evaluation is required under Topic 323 on the adoption date and, if so, performs that evaluation. If necessary, the investor recognizes an impairment loss in the income statement and reduces the investment's carrying amount on the date of adoption. Chapter 5 of KPMG Handbook, Equity method of accounting, discusses and illustrates application of the Topic 323 impairment guidance.

- When adopting the removal of the cost method guidance, an investor determines whether it must account for the investment at fair value under Topic 321 and, if not, whether it elects to account for the investment at fair value or using the Topic 321 measurement alternative.

  – If the investor accounts for the investment at fair value, it adjusts the investment's carrying amount to fair value on the adoption date with a corresponding entry to current-period income or loss.

  – If the investor accounts for the investment using the Topic 321 measurement alternative, after adoption, the investor adjusts the investment's carrying amount to its fair value in accordance with Topic 321 when there are observable transactions for the underlying equity security or the investment is impaired. Chapter 5 of KPMG Handbook, Investments, discusses and illustrates application of the Topic 321 measurement alternative.

- When adopting the limitation of the delayed equity contributions guidance, an investor reverses any delayed equity contributions liability it has recognized for an LIHTC investment to which the PAM has not been applied and reduces the investment's carrying amount. In this case there is no effect on current period income or loss.

Contributing authors

Kimber Bascom, Matt Drucker, Angie Storm, Teresa Dimattia, and Jenna Terrell

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