



Tax credits

Handbook

US GAAP

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Tax credits: pretax or income tax, or some of each

Have you ever tried to compare the impacts of tax credits on the effective tax rate across entities? What you might find is that the tax credits can take a straight or circuitous path to the income tax line, and some don't end up there at all.

While tax credits are typically claimed on the income tax return, there is diversity in how they are accounted for in the financial statements. This diversity arises from a number of factors, including:

- who generates the tax credit and how the reporting entity obtains the tax credit;
- how the tax credit is realized; and
- what the tax credit is trying to incentivize.

Adding to this diversity are the policy choices in US GAAP, as well as those practices that have developed over time as entities try to apply the limited guidance available.

As if there were not enough sources of diversity when it comes to accounting for tax credits, recent legislation gave rise to new sources by introducing mechanisms to monetize some tax credits that are novel to US federal tax law – including elections for direct pay and third-party transfer.

Signs point to tax credits continuing to be an important instrument to control tax costs and/or support social responsibility initiatives. So, all of these sources of diversity aren't going anywhere any time soon.

This Handbook walks you through the considerations involved in navigating the path for your tax credits. We hope you find the explanation and examples useful in understanding when and where tax credits are recorded and the array of policy choices that are applied in practice.

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About this publication

The purpose of this publication is to assist you in understanding the accounting for tax credits in accordance with US GAAP, which can be quite different depending on their nature and characteristics, as well as an array of policy choices that are applied in practice. Presenting the accounting for tax credits in a single publication allows us to more easily compare and contrast the accounting results for the different types of tax credits and policy choices available.

Organization of the text

Entities typically generate tax credits directly through participation in certain activities or ownership of qualifying property, or indirectly through ownership of interests in pass-through entities. On the direct path, entities consider whether the tax credit is refundable and/or transferrable. On the indirect path, entities consider the accounting model(s) applicable to investments in pass-through entities. As illustrated in the Executive summary, this Handbook is organized based on these two paths and the key considerations involved in each.

This Handbook focuses on the accounting for tax credits and not the accounting for the underlying property or activity that gives rise to the tax credit, which falls under Topic 360 (property, plant and equipment) or other US GAAP, as applicable. In addition, while this Handbook addresses the accounting for tax credits generated by an entity's equity method investees, it does not address the ongoing application of the equity method of accounting, which falls under Topic 323 (investments – equity method and joint ventures) and is discussed in depth in KPMG Handbook, [Equity method of accounting](#).

This Handbook makes reference to the FASB's Accounting Standards Codification® (ASC) and other literature, where applicable. The following are examples.

- 323-740-25-1 is paragraph 25-1 of ASC Subtopic 323-740 (investments – equity method and joint ventures – income taxes)
- ASU 2023-02.BC11 is paragraph 11 of the basis for conclusions to Accounting Standards Update No. 2023-02, Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method
- IAS 20.23 is paragraph 23 in International Accounting Standards 20, Accounting for Government Grants and Disclosure of Government Assistance, under IFRS® Accounting Standards

Recent developments

Tax law changes

The Inflation Reduction Act (IRA) and CHIPS and Science Act (CHIPS) of 2022 introduced:

- a substantial package of new and extended energy and climate-related tax credits;
- a new one-time investment tax credit equal to 25% of an entity's investment in facilities that manufacture semiconductors or semiconductor manufacturing equipment; and
- mechanisms for monetizing some credits that are novel to US federal tax law – including elections for 'direct pay' and third-party transfer.

The IRA also allows for increased and bonus credits if an entity meets certain criteria.

Accounting standards update

In March 2023, the FASB issued ASU 2023-02, which expands the population of investments for which an investor may elect to apply the PAM (see [chapter 6](#)). Under the ASU, an investor can elect the PAM for qualifying investments on a tax-credit-program-by-program basis. To qualify for the PAM, an investment must meet certain criteria, as clarified by the ASU. Disclosures are required on an interim and annual basis for investments in tax credit programs for which the PAM is elected, including those where the PAM is not applied.

The ASU 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.

This Handbook is prepared on the basis of the guidance in Subtopic 323-740, as amended by ASU 2023-02. Appendix B of KPMG Handbook, [Accounting for income taxes](#), provides guidance applicable prior to adoption of the ASU.

Abbreviations

We use the following abbreviations in this Handbook:

CHIPS	CHIPS and Science Act of 2022
CIP	Construction-in-progress
EBITDA	Earnings before interest, taxes, depreciation and amortization
HLBV	Hypothetical liquidation at book value
IRA	Inflation Reduction Act of 2022
ITC	Investment tax credit

LIHTC	Low-income housing tax credit
NCI	Noncontrolling interest
NIC	National insurance contributions
PAM	Proportional amortization method
PAYE	Pay-as-you-earn
PPE	Property, plant and equipment
PTC	Production tax credit
RDEC	Research and development expenditure credit

1. Executive summary

Although tax credits are typically claimed on an income tax return, not all tax credits are in the scope of Topic 740 (income taxes). The accounting for tax credits under US GAAP depends on how the credit may be realized and what it is trying to incentivize, along with the general characteristics and nature of the credit.

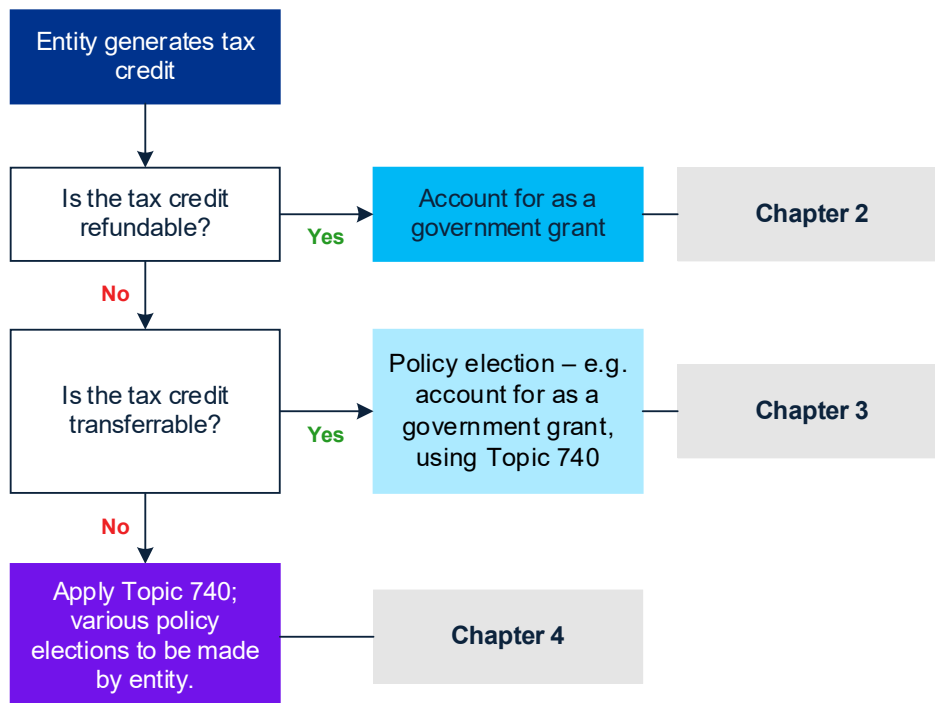
Entities typically generate tax credits directly through participation in certain activities or ownership of qualifying property, or indirectly through ownership of interests in pass-through entities. The accounting requirements for tax credits under US GAAP depend on the foundational question of who generates the tax credit – the entity or a tax credit structure (i.e. pass-through entity) the entity invests in.

Entity generates the tax credit

Entities can generate tax credits through participation in certain activities or ownership of qualifying property.

When evaluating the accounting consequences of tax credits, an entity considers the underlying characteristics of the credit, including whether the credit is refundable or transferable.

The following decision tree outlines the key considerations in accounting for the tax credits generated by the entity.



Refundable credits

The benefits of these credits are not limited by an entity's taxable income or tax liability.

We believe refundable credits should be accounted for consistent with an entity's policy on government grants.

Because US GAAP does not provide specific guidance on how to account for government grants, entities may analogize to:

- IAS 20, Accounting for government grants and disclosure of government assistance, under IFRS® Accounting Standards;
- Subtopic 958-605, Not-for-Profit Entities – Revenue recognition; or
- Subtopic 450-30, Gain contingencies.

Read more: [Chapter 2](#)

Transferable credits

The benefit of a nonrefundable, transferable credit may be realized through the transfer of the credit to another unrelated taxpayer in exchange for cash or other consideration.

The transferability feature introduces more complexity to the accounting for a credit when it arises and when it is sold.

Because US GAAP does not address how transferability affects the accounting for credits, we believe there are a number of acceptable approaches, including:

- Topic 740;
- grant accounting; or
- an intent-based model (in certain circumstances).

There are additional accounting considerations if the entity sells the credit, and for the entity that purchases the credit.

Read more: [Chapter 3](#)

Nonrefundable, nontransferable credits

The benefits of these credits are realizable only if the entity has an income tax liability.

These credits are accounted for under Topic 740, and, if related to the acquisition of an asset, using the flow-through or deferral method.

If the deferral method is used, policy choices must be made for:

- the method of presenting the deferral of the benefit;
- the method of recognizing deferred taxes; and
- the method of presenting the deferred benefit.

Read more: [Chapter 4](#)

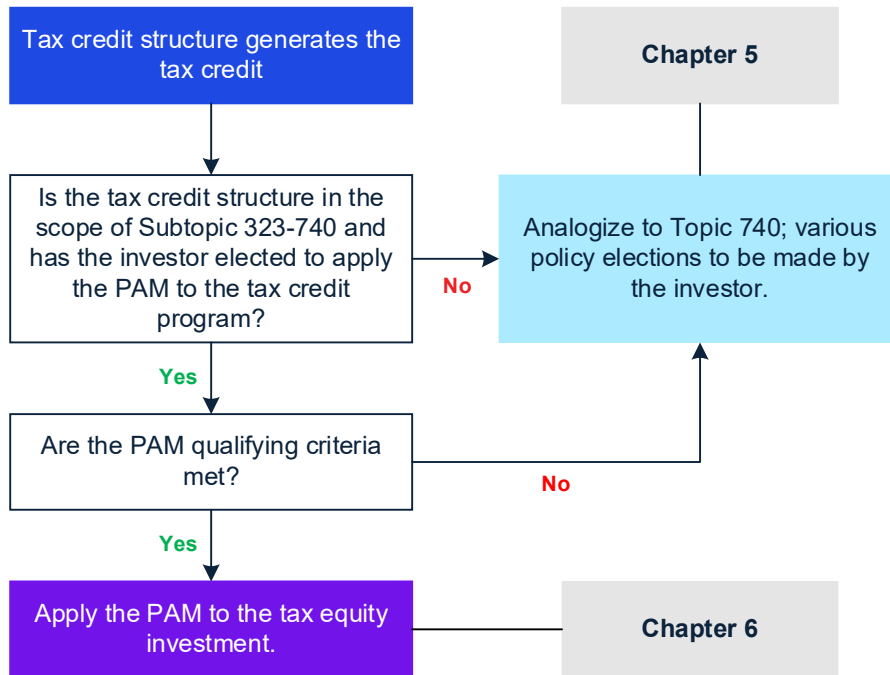
Tax credit structure generates the tax credit

Developers of projects that generate tax credits may seek to monetize the tax credits by partnering with tax equity investors. These arrangements generally result in tax equity investors making investments into a pass-through entity that will generate tax credits and tax deductions that are passed through to the tax equity investors.

The tax equity investors receive a return from the investment through allocated tax losses, cash distributions or redemptions and the allocated tax credits. In exchange, the sponsor of the structure keeps a greater percentage of the pass-through entity's recognized net assets.

Depending on the facts and circumstances, investments in tax credit structures might be accounted for using the equity method, Topic 321 (investments in equity securities) or the PAM.

The following decision tree highlights the main considerations and outcomes for an investor's accounting for tax credits generated by tax credit structures.



Investors in tax credit structures

As US GAAP does not address the accounting for tax credits allocated to tax equity investors (except when the PAM is elected), we believe it is appropriate to analogize to the guidance on how to recognize tax credits arising from direct participation in certain activities or direct investments in qualifying assets.

Similar to nonrefundable, nontransferable credits generated directly by an entity, policy choices must be made for ITCs allocated to an investor that are in the scope of Topic 740. Those policy choices relate to:

- the use of the flow-through or deferral method;
- the method of recognizing deferred taxes;
- the method of presenting the deferred benefit; and
- the method of recognizing a decrease in the entity's capital account when applying the equity method.

Read more: [Chapter 5](#)

Proportional amortization method

An investor in limited liability entities may elect the PAM on a tax credit program-by-program basis. For example, an investor may elect the PAM for the LIHTC program, but not elect it for the rehabilitation tax credit program.

Once the PAM has been elected for one or more tax credit programs, the investor determines whether the PAM qualifying criteria are met for each of its investments generating credits from those tax credit programs. The PAM is only applied to an investment if it meets all the criteria.

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) allocated to it. Periodic amortization is calculated based on the proportion of the income tax benefits received during the period to the total income tax benefits expected to be received over the life of the investment.

Disclosures are required for investments in tax credit programs for which the PAM is elected, including those where the PAM is not applied.

Read more: [Chapter 6](#)

2. Refundable credits

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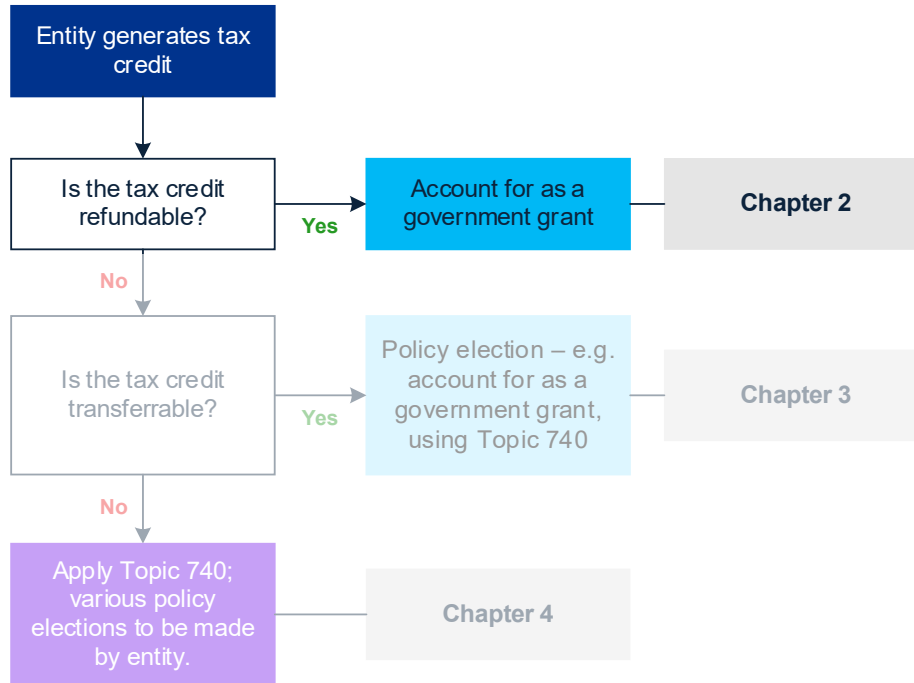
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- 2.3.10 Refundable production tax credits and eligible bonus credits
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2.1 How the standard works

This chapter addresses the accounting for refundable tax credits.



Certain jurisdictions provide refundable credits that are not dependent on the existence of an entity’s taxable income or income tax liability (e.g. an entity may receive a refund from the government despite being in a taxable loss position). Although the claims are often filed in connection with the entity’s income tax return, the credits are not income taxes in the scope of Topic 740. Therefore, the benefit is not recorded as a reduction to income tax expense.

We believe tax credits are government grants to the extent they are refundable even if the entity intends to use them to offset an income tax liability instead of receiving a cash refund. US GAAP currently provides no specific guidance on how business entities should account for government grants and therefore entities have to apply accounting models by analogy.

Future developments

The FASB has a project on its research agenda to consider incorporating the recognition, measurement and presentation guidance on accounting for government grants in IAS 20 into US GAAP. To obtain feedback from stakeholders on how to proceed with the project, the FASB issued an Invitation to Comment. The comment period ended September 12, 2022. See KPMG web article, [FASB seeks feedback on potential incorporation of IAS 20](#), for additional discussion.

2.2 Accounting for refundable credits

We believe refundable credits should be accounted for consistent with an entity’s policy on accounting for government grants. While there is diversity in practice in accounting for government grants, many entities have an existing policy to analogize to one of three primary accounting models.

Accounting model	Description
IAS 20 (grant model)	Entity recognizes the grant when it has reasonable assurance that (1) it will comply with the grant’s relevant conditions and (2) the grant will be received. The grant is recognized in profit or loss on a systematic basis in line with its recognition of the costs that the grant is intended to compensate.
Subtopic 958-605 (contribution model)	Entity recognizes income from a ‘conditional’ contribution (credit) when the conditions on which the contribution depends are substantially met.
Subtopic 450-30 (gain contingency model)	Entity recognizes income related to the contingency when that income is realized or realizable.

Policy elections made in connection with the accounting for refundable tax credits should be consistent with prior policy elections for similar types of government grants. Entities considering a voluntary change in accounting policy need to evaluate preferability. Preferability is determined on the merits of the accounting principle – i.e. whether it is an improvement in financial reporting. Refer to section 3.3 of KPMG Handbook, [Accounting changes and error corrections](#), for further discussion.

2.2.10 IAS 20 (grant model) approach

Recognition

Under IAS 20, an entity recognizes a government grant when it has reasonable assurance that (1) it will comply with the grant’s relevant conditions and (2) the grant will be received. We understand the SEC staff equates reasonable assurance to probable (likely to occur) under US GAAP.

Judgment is often required when evaluating whether the IAS 20 conditions are met. In assessing if it is probable that an entity will meet the recognition conditions in IAS 20, we believe the entity should consider the following factors:

- uncertainties about eligibility;
- its experience (or other evidence) with similar types of arrangements;
- whether receiving the grant and meeting the conditions is primarily in its control and not highly susceptible to factors outside its influence (e.g. the judgment or actions of third parties, weather conditions);

- its ability to avoid repayment of the grant (i.e. recapture of the credit) or other liabilities associated with a failure to comply with the grant’s terms (i.e. a penalty); and
- the amount of time until the uncertainty about meeting the conditions and receiving the credit is expected to be resolved.

In some cases, an entity may conclude that the recognition criteria in IAS 20 are met before the grant is received – i.e. before the credit is available. In that case, we believe an entity would generally need to recognize the grant in a systematic and rational manner based on the amount that it is probable to receive based on the credit-generating activities performed as of the reporting date. For example, an entity may recognize a grant receivable in proportion to its spend on the activities that will generate the credit.

We believe an entity does not recognize a grant receivable related to activities it will perform in the future because such a receivable does not meet the characteristics of an asset under FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting - Chapter 4, Elements of Financial Statements.

If conditions (1) and (2) of IAS 20 are met, an entity recognizes the benefits of the grant in pretax income on a systematic basis in line with its recognition of the costs that the grant is intended to compensate.

The following table summarizes the timing of income recognition.

Grant related to	Timing of recognition in profit or loss
Depreciable asset	As the asset is depreciated/amortized
Non-depreciable asset	Consistent with conditions related to the grant. For example, if a grant is related to the purchase of land on the condition that the entity constructs and operates a building on that land, the grant is recognized in profit or loss as the building is depreciated.
Income to compensate for specific costs	On a systematic basis over the periods when the related costs are recognized as expenses
Income to compensate for expenses or losses already incurred or to provide immediate financial support with no future related costs	When the grant becomes receivable

Measurement

For a government grant in the form of a monetary asset (e.g. a refundable credit), we believe an entity measures the grant based on the amount the entity expects to receive, without consideration of the time that may pass before the grant (i.e. credit) is received (i.e. the grant is not discounted).

Presentation

For presentation of the benefits of grants **related to assets**, an entity makes a policy election to either:

- deduct the grant from the cost of the asset (net presentation) and therefore is recognized through reduced depreciation expense; or
- present the grant separately as deferred income (gross presentation) to be amortized over the useful life of the asset based on a policy election as either:
 - income (including refundable credits that initially reduce the carrying amount of the asset); or
 - a reduction in expense (typically depreciation expense).

Temporary differences may arise under either approach – e.g. if the tax law only provides a partial reduction of the tax basis of the qualifying property. In that case, an entity recognizes the related deferred taxes. We believe an entity should generally recognize those deferred taxes using the simultaneous equation approach (see KPMG Handbook, [Accounting for income taxes](#), from paragraph 10.001), but there may be other acceptable approaches.

The simultaneous equation determines the appropriate deferred taxes (and the corresponding adjustment to the initial carrying amount of the asset) as follows:

$$(\text{tax rate} \div (1 - \text{tax rate})) \times (\text{tax basis} - \text{net carrying amount on balance sheet})$$

For grants **related to income**, an entity makes a policy election to present the benefit as:

- other income (gross presentation); or
- an offset to the related costs (net presentation).

The accounting for refundable credits by analogy to IAS 20 is illustrated in [Example 2.2.10](#).

2.2.20 Subtopic 958-605 (contribution model) approach

Some entities apply Subtopic 958-605 by analogy to account for government grants. Although Subtopic 958-605 excludes transfers of assets from government entities to business entities, the FASB staff has noted that business entities are not prohibited from analogizing to that guidance to account for government grants.

Under this approach, a government grant may be treated as a ‘contribution’. If the contribution is unconditional, the grant is recognized immediately in income when received. In contrast, income from a ‘conditional’ contribution is recognized when the conditions on which the contribution depends are substantially met.

Conditional contributions are those that include:

- one or more barriers that must be overcome before the recipient is entitled to the benefit; and
- a right of return.

An entity does not consider the likelihood that the conditions will be met when determining whether barriers exist.

Determining whether the conditions necessary to avoid recapture or penalty of refundable credits are 'barriers' and, if so, when they are 'substantially met' may require judgment. Applying this guidance could result in an entity deferring the recognition of the benefit until the recapture or penalty period has lapsed.

2.2.30 Subtopic 450-30 (gain contingency model) approach

Some entities apply Subtopic 450-30 by analogy to account for government grants. Under this approach, an entity does not recognize income related to the grant (i.e. the refundable credit) until it is realized or realizable.

In assessing whether the refundable credit is realized or realizable, an entity considers its ability to avoid recapture of the credit or a penalty.

2.2.40 Financial statement presentation and disclosures

Balance sheet presentation of a right to receive a refundable credit

US GAAP currently provides no specific guidance on how an entity classifies the right to a government grant (e.g. a refundable credit) on the balance sheet. We believe an entity should generally present the right to receive a refundable credit as:

- a reduction of income taxes payable if it expects to realize the benefit through a reduction of its income tax liability;
- an 'other receivable' or 'other asset' if it expects to receive cash for the excess of the credit amount over its income tax liability; or
- income taxes refundable if it expects to apply the refundable credit as a payment against future income taxes.

We believe it would be inappropriate to reduce the income taxes payable balance of another tax-paying component/jurisdiction for the credit. This is because the 'right of setoff' conditions in Subtopic 210-20 would not be met.

Statement of cash flows presentation

The presentation of refundable tax credits in the statement of cash flows depends on whether the entity uses the credit to offset an income tax liability or receives a cash refund.

Entity uses credit to offset income tax liability

An entity discloses the amount of income taxes paid when it uses the indirect method to prepare its statement of cash flows. We believe this amount is net of refundable credits that were actually used in the period to reduce the amount of cash paid for income taxes – i.e. the portion of credits refunded in cash (or to be refunded) do not reduce ‘income taxes paid’.

Entity receives cash refund

Topic 230 provides no guidance on how to classify proceeds from government grants. Therefore, judgment is necessary, taking into consideration the accounting approach selected, the conditions of the grant and the timing of receipt.

As discussed in [section 2.2.10](#), for refundable credits relating to assets, an entity may choose to deduct the amount from the cost of the asset or present it separately as deferred income. When those credits are refunded in cash, we believe classification generally aligns with the chosen balance sheet presentation as follows.

- Cash received for credits presented as a depreciable contra-asset is an investing cash inflow.
- Cash received for credits presented as deferred income is an operating cash inflow.

For refundable credits relating to income (including refundable credits that are capitalized in inventory), we believe the cash received is generally an operating cash flow.

Policy elections made should be consistent with policy elections for similar types of government grants. See section 23.3 of KPMG Handbook, [Statement of cash flows](#).

Disclosures

If a business entity accounts for refundable credits using the grant or contribution model (i.e. analogizes to IAS 20 or Subtopic 958-605), it provides disclosures under Topic 832 (government assistance) in its financial statements for annual periods beginning after December 15, 2021 (effective date is the same for all entities in the scope of ASU 2021-10, Government Assistance (Topic 832): Disclosures by Business Entities about Government Assistance).

Topic 832 disclosure requirements include:

- the nature of the transactions, including the form of the assistance;
- the accounting policies used to account for the transactions;
- the line items on the balance sheet and income statement that are affected and the amounts applicable to each financial statement line item in the reporting period; and
- significant terms and conditions of the transactions.

See KPMG Issues In-Depth, [Government assistance disclosures](#), for additional discussion.

Because Subtopic 450-30 on gain contingencies is neither a contribution nor grant model, an entity applying that model for its government grants does not have disclosure requirements under Topic 832. Instead, the entity considers disclosures related to a contingency that might result in a gain. However, it should take adequate care to avoid misleading implications as to the likelihood of realization. Specific disclosures should enable a reader to understand the scope of the contingencies affecting the entity.

Example 2.2.10

Refundable production tax credit (IAS 20)

Background

ABC Corp operates in Country X, which provides a production tax credit (PTC) for eligible battery cells that are produced in Country X and subsequently sold to unrelated third parties. The PTC is refundable through a direct pay mechanism and is nontaxable.

In Year 1, ABC produces qualifying battery cells at a cost of \$5,000,000 and will generate a tax credit of \$1,000,000.

ABC sells 80% of the battery cells produced and the remaining 20% remain in inventory. ABC has contracted for the sale of the remaining battery cells in Year 2, so it is probable that the battery cells remaining in inventory will be sold and the entire \$1,000,000 grant will be received. ABC has complied with the relevant conditions to have \$800,000 of the tax credits available in Year 1 and it expects \$200,000 of the tax credits to be available in Year 2.

Other information

ABC does not make the direct pay election on its tax return for Year 1 and does not expect to make the direct pay election on its tax return for Year 2. Instead, ABC uses the credits to offset its income tax liability that would otherwise be due.


Policy elections

ABC has an existing policy to account for government grants by analogy to IAS 20. It elects to present the benefit as an offset to the related costs (initially inventory and later as cost of goods sold).

ABC records the following journal entries in Year 1.

	<i>Debit</i>	<i>Credit</i>
Inventory	5,000,000	
Cash/Accounts payable		5,000,000
<i>To recognize the production of the battery cells.</i>		

	<i>Debit</i>	<i>Credit</i>
Cost of goods sold	4,000,000 ¹	
Inventory		4,000,000 ¹
<i>To recognize cost of goods sold.</i>		
Income taxes payable	800,000 ²	
Other asset	200,000 ²	
Cost of goods sold		800,000 ²
Inventory		200,000 ²
<i>To recognize PTC as offset to related costs.</i>		
Notes:		
<ol style="list-style-type: none"> 80% of the total battery cells produced in Year 1 are sold. The remaining 20% remain in inventory. The PTC arises upon the production and sale of the eligible battery cells. Although 20% of the battery cells remain in inventory, it is probable they will be sold in Year 2. Since both conditions under IAS 20 are met, ABC recognizes the grant with 80% as an offset to cost of goods sold and 20% as an offset to inventory. We believe ABC should present the portion of the PTC that is probable but not currently available to the entity (the 20% presented in inventory) as an other asset. Once it becomes available to ABC, we believe it should be reclassified to income taxes refundable. 		



Example 2.2.20

Refundable investment credit (IAS 20) – Acquisition of qualifying asset

Background

ABC Corp operates in Country X, which provides an investment credit equal to 25% of the basis of qualifying property placed in service during the year. The credit is refundable through a direct pay mechanism. The credit is nontaxable and ABC must reduce its tax basis in the property by 100% of the credit amount.

On January 1, Year 1, ABC acquires the qualifying property for \$100,000,000 and places it in service. The qualifying property is depreciated for financial statement and income tax purposes on a straight-line basis over a 25-year period. At the time of the purchase, ABC determines it is probable that it will generate the full 25% credit and expects to comply with any requirements to avoid recapture or penalties.

Other information

ABC does not make the direct pay election on its tax return for Year 1; instead, ABC uses the credits to offset its income tax liability for Year 1.

Because the investment credit results in 100% tax basis reduction and the credit reduces the carrying value of the asset, there is no temporary difference to account for.

ABC has a 21% statutory income tax rate.

Policy elections

ABC has an existing policy to account for government grants by analogy to IAS 20 and to initially present the benefit as a reduction to the cost of the asset and later recognize it through reduced depreciation expense.

It records the following journal entries on January 1, Year 1.

	<i>Debit</i>	<i>Credit</i>
PPE	100,000,000	
Cash		100,000,000
<i>To recognize the acquisition of the qualifying property.</i>		
Income taxes payable	25,000,000	
PPE		25,000,000
<i>To recognize the investment credit (net presentation).</i>		

ABC records the following journal entries in Year 1.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense	3,000,000 ¹	
PPE (accum. depr)		3,000,000
<i>To recognize depreciation expense.</i>		
Income taxes payable	630,000 ²	
Current tax expense		630,000
<i>To recognize the benefit of tax depreciation to be taken on the Year 1 tax return.</i>		
Notes:		
1. (cost of \$100,000,000 less tax credits of \$25,000,000) ÷ 25 years		
2. Tax basis of \$75,000,000 (\$100,000,000 cost, less \$25,000,000 of tax credits generated) over 25 years results in tax depreciation of \$3,000,000 × 21%.		

Example 2.2.30

Refundable investment credit (IAS 20) – Construction of qualifying asset

Background

ABC Corp operates in Country X, which provides an investment credit equal to 25% of the basis of certain qualifying assets placed in service during the year. The tax credit is refundable through a direct pay mechanism. The credit is nontaxable and ABC must reduce its tax basis in the property by 100% of the credit amount.

On January 1, Year 1, ABC announces it will begin construction on a new manufacturing facility, which is a qualified asset for the investment credit. The construction of the facility costs \$75,000,000 and generates a \$18,750,000 credit. The construction begins in Year 1 and is completed on December 31, Year 3.

The facility is placed in service on January 1, Year 4 and is depreciated over a 25-year period for financial statement and income tax purposes.

ABC makes the direct pay election on its tax return for Year 4 and expects to receive the credit through a cash refund. In Year 5, after filing its Year 4 tax return, ABC receives the \$18,750,000 payment of the investment credit.

ABC incurs the expenses for the construction of the manufacturing facility as follows.

Year	Amount (\$)
1	25,000,000
2	30,000,000
3	20,000,000

Each year, ABC determines that it is probable it will comply with any requirements to avoid recapture and will generate the full 25% credit.

Other information

Because the investment credit results in 100% tax basis reduction and the credit reduces the carrying value of the asset, there is no temporary difference to account for.

ABC has a 21% statutory income tax rate.

Policy elections

ABC has an existing policy to account for government grants by analogy to IAS 20. It initially presents the benefit as a reduction to the cost of the asset and later presents it through reduced depreciation expense. It will recognize an other receivable in proportion to construction spend.

Year 1

It records the following journal entries in Year 1.

	<i>Debit</i>	<i>Credit</i>
Construction-in-progress (CIP)	25,000,000	
Cash		25,000,000
<i>To recognize the Year 1 costs incurred for the construction of the qualifying asset.</i>		
Other receivable	6,250,000 ¹	
CIP		6,250,000
<i>To recognize the investment credit (net presentation).</i>		

Note:

1. \$25,000,000 qualifying expenditures × 25% credit.

Year 2

ABC records the following journal entries in Year 2.

	<i>Debit</i>	<i>Credit</i>
CIP Cash <i>To recognize the Year 2 costs incurred for the construction of the qualifying asset.</i>	30,000,000	30,000,000
Other receivable CIP <i>To recognize the investment credit (net presentation).</i>	7,500,000 ¹	7,500,000
Note: 1. \$30,000,000 qualifying expenditures × 25% credit.		

Year 3

ABC records the following journal entries in Year 3.

	<i>Debit</i>	<i>Credit</i>
CIP Cash <i>To recognize the Year 3 costs incurred for the construction of the qualifying asset.</i>	20,000,000	20,000,000
Other receivable CIP <i>To recognize the investment credit (net presentation).</i>	5,000,000 ¹	5,000,000
Note: 1. \$20,000,000 qualifying expenditures × 25% credit.		

Year 4

ABC records the following journal entries in Year 4.

	<i>Debit</i>	<i>Credit</i>
PPE CIP <i>To recognize the facility being placed into service.</i>	56,250,000 ¹	56,250,000
Depreciation expense PPE (accum. depr) <i>To recognize depreciation expense.</i>	2,250,000 ²	2,250,000

	<i>Debit</i>	<i>Credit</i>
Income taxes payable	472,500 ³	
Current tax expense		472,500
<i>To recognize the benefit of tax depreciation to be taken on the Year 4 tax return.</i>		
Notes:		
1. \$75,000,000 PPE, net of \$18,750,000 investment credit.		
2. PPE, net (\$75,000,000 – \$18,750,000) ÷ 25 years.		
3. Tax basis of \$56,250,000 (\$75,000,000 cost, less \$18,750,000 of tax credits generated) over 25 years results in tax depreciation of \$2,250,000 × 21%.		

Year 5

ABC records the following journal entries in Year 5.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense	2,250,000 ¹	
PPE (accum. depr)		2,250,000
<i>To recognize depreciation expense.</i>		
Income taxes payable	472,500 ²	
Current tax expense		472,500
<i>To recognize the benefit of tax depreciation to be taken on the Year 5 tax return.</i>		
Cash	18,750,000	
Other receivable		18,750,000
<i>To recognize the receipt of the credit</i>		
Notes:		
1. PPE, net (\$75,000,000 – \$18,750,000) ÷ 25 years.		
2. Tax basis of \$56,250,000 (\$75,000,000 cost, less \$18,750,000 of tax credits generated) over 25 years results in tax depreciation of \$2,250,000 × 21%.		

2.3 Other application issues

2.3.10 Inflation Reduction Act and CHIPS and Science Act

In August 2022, President Joseph R. Biden signed into law two pieces of legislation with significant tax implications:

- H.R. 5376, commonly referred to as the Inflation Reduction Act of 2022 (IRA); and
- H.R. 4346, commonly referred to as the CHIPS and Science Act of 2022 (CHIPS).

The IRA introduces new energy-related tax credits. CHIPS adds a one-time investment credit equal to 25% of an entity's investment in facilities that manufacture semiconductors or semiconductor manufacturing equipment.

The laws also introduce mechanisms for monetizing some credits that are novel to US federal tax law – including elections for 'direct pay' and third-party transfer. The IRA also allows for increased and bonus credits if an entity meets certain criteria.

Introduction of direct pay election

The availability of the direct pay election varies by credit. The direct pay election is available to all taxpayers for the following specific credits:

- Section 48D credit for investments in semiconductor manufacturing;
- Section 45Q credit for carbon capture and sequestration;
- Section 45V credit for clean hydrogen production; and
- Section 45X credit for the advanced manufacturing production tax credit.

Other credits included in the IRA provide a direct pay election for credit-eligible projects owned by certain tax-exempt and government entities.

Because the direct pay election allows a taxpayer to treat an eligible credit as a direct payment of tax, a taxpayer can receive a cash payment if it does not incur any income tax liability. If the direct pay election is available (regardless of whether the taxpayer expects to elect direct pay), it applies the refundable credit accounting described in [section 2.2](#).

Certain credits have the direct pay election for a specified period. For credits that arise in periods in which the direct pay election is not available, an entity accounts for the credit consistent with the characteristics of the credit (nonrefundable, nontransferable, or refundable, transferable).

For the specific provisions of each credit, refer to the following resources:

- KPMG Report, [Analysis and observations: Tax law changes in the "Inflation Reduction Act of 2022"](#)
- KPMG Report, [Overview of investment tax credit for investments in semiconductor manufacturing](#)

Increased and bonus credits

For some of these refundable credits, there are also increased and bonus credits available to entities meeting certain conditions. Some of the increased credits are available if the following conditions are satisfied.

- **Prevailing wage requirement:** Entities must ensure laborers and mechanics employed by contractors are paid prevailing wages during construction and, in some cases, for alteration and repairs for a period of time after the project is placed in service.
- **Apprenticeship requirement:** Entities must ensure that a specified percentage of total labor hours are performed by qualified apprentices.

Additional bonus credits are available if facilities are composed of steel, iron and other products manufactured in the US – i.e. the facilities meet ‘domestic content requirements’.

Increased and bonus credits often arise in the same period as the base credits, but also generally require entities to continue to meet certain conditions during a specified compliance period. An entity has to assess its ability to comply with the prevailing wage, apprenticeship and/or domestic content requirements to avoid incurring a penalty or disallowance of the increased or bonus rate.

The following table summarizes accounting considerations for increased and bonus credits based on an entity’s accounting policy election.

Analogize to	Accounting considerations
IAS 20	IAS 20 does not address if and when a grant should be separated into multiple grants (i.e. unit of account). An entity needs to consider the facts and circumstances of the base, increased and bonus credits in determining whether these credits should be accounted for as an individual grant or multiple grants.
Subtopic 958-605	Determining whether barriers exist and when they are substantially met may require judgment. Applying the guidance in Subtopic 958-605 could result in an entity deferring the recognition of the benefit until the compliance period has lapsed.
Subtopic 450-30	Entity recognizes income related to the increased and bonus credits when that income is realized or realizable.


The accounting for refundable credits and related increased credits by analogy to IAS 20 is illustrated in [Example 2.3.10](#).

As discussed in [section 2.2.10](#), if the conditions in IAS 20 are met, an entity recognizes the benefits of the grant in pretax income on a systematic basis in line with its recognition of the costs that the grant is intended to compensate.

Determining which expenses the grant is intended to compensate will require judgment. For example, certain increased and bonus credits are arguably intended to compensate the taxpayer for the incremental costs:

- during the construction period to comply with the prevailing wage, apprenticeship and domestic content requirements; and
- during a specified repair (or improvement) period after construction to continue to comply with prevailing wage requirements.

The credits may be compensating for expenditures that are capitalized in the related asset balance and/or expenses incurred during the period.



Example 2.3.10

Refundable production tax credits and eligible bonus credits

Background

ABC Corp operates in Country X, which provides a production tax credit (PTC) for the production of qualified clean hydrogen at a qualified production facility. The PTC is refundable through a direct pay mechanism and nontaxable. The PTC is available during a 10-year period beginning on the date the qualified production facility is placed in service.

Other information

ABC does not have an income tax liability for Years 1 and 2. As a result, it will make the direct pay election on its tax return in both years and expects to receive the credit through a cash refund.

Policy elections

ABC has an existing policy to account for government grants by analogy to IAS 20 and to present the benefit as other income.

Year 1

In Year 1, the qualified production facility is placed in service and ABC produces 10 million kilograms of qualified clean hydrogen at a cost of \$70,000,000. ABC has complied with the relevant conditions and is eligible for a base tax credit of \$6,000,000 (base rate of \$0.60 per kilogram).

ABC may claim the PTC at an increased rate (five times the base rate) if it satisfies:

- prevailing wage requirements during the construction period of the production facility and for the duration of the 10-year PTC period; and
- apprenticeship requirements during the construction period.

ABC satisfied the prevailing wage and apprenticeship requirements. Therefore, a combined base and increased credit of \$30,000,000 arises for ABC's Year 1 tax return. ABC sells all of the hydrogen produced in Year 1 during Year 1.

ABC records the following journal entries in Year 1.

	<i>Debit</i>	<i>Credit</i>
Cost of sales	70,000,000	
Cash/Accounts payable		70,000,000
<i>To recognize the cost of production and sale of the clean hydrogen.</i>		
Other receivable	30,000,000 ¹	
Other income		30,000,000
<i>To recognize base and increased PTC as other income.</i>		

Note:

1. 10,000,000 kilograms of qualified clean hydrogen × \$3 (\$0.60 per kilogram × 5 increased rate).

Year 2

In Year 2, ABC produces 15 million kilograms of qualified clean hydrogen at a qualified production facility at a cost of \$105,000,000. ABC has complied with the relevant conditions of the credit and continues to satisfy the prevailing wage requirements. Therefore, a combined base and increased credit of \$46,500,000 (five times the base rate of \$0.62 per kilogram after inflation adjustment) arises for ABC's Year 2 tax return. ABC sells all of the hydrogen produced in Year 2 during Year 2.

ABC records the following journal entries in Year 2.

	<i>Debit</i>	<i>Credit</i>
Cost of sales	105,000,000	
Cash/Accounts payable		105,000,000
<i>To recognize the cost of production and sale of the clean hydrogen.</i>		
Other receivable	46,500,000 ¹	
Other income		46,500,000
<i>To recognize base and increased PTC as other income.</i>		
Note:		
1. 15,000,000 kilograms of qualified clean hydrogen × \$3.10 (\$0.62 per kilogram × 5 increased rate).		

2.3.20 United Kingdom Research and Development Expenditure Credit

The United Kingdom (UK) Research and Development Expenditure Credit (RDEC) is a refundable credit. The UK government provides an RDEC for larger entities in the UK for qualifying expenditures incurred. The key terms of the RDEC include the following.

- Entities generally are entitled to a gross credit of 13% of qualifying R&D expenditures (certain trades are entitled to a higher rate of 49%).
- The gross credit is taxable.
- The credit offsets the corporation tax liability of a tax-paying entity.
- If there is no corporation tax liability (or the credit exceeds the corporation tax liability), the entity can receive the credit in cash (subject to conditions; see below).

- Any credit that exceeds the corporation tax liability for the period is restricted to the combination of the entity's PAYE (pay-as-you-earn system for employee withholding taxes) and NIC (national insurance contributions) liabilities for the entity and group employees involved in R&D activities. Any credit that exceeds this amount can be carried forward to be claimed in the following year.
- The credit is offset against the corporation tax liability for other accounting periods and may be offset against the corporation tax liability of other group entities.
- Payment in cash may be restricted if there are outstanding PAYE/NIC liabilities, if the entity is subject to an open corporation tax inquiry for the period, or if the entity is not a going concern (as defined in the legislation).

The amount of cash received will be net of tax. The notional tax incurred may be surrendered to other group entities or carried forward for offset against future income tax liabilities.

As it relates to the RDEC, the UK income tax system serves only as a mechanism for administering the refunds to eligible parties. Accordingly, we believe the tax credit is not income-based and is outside the scope of Topic 740. Therefore, the benefit of the entire credit is presented in pretax income either as other income or as a deduction from the related expenditures; the credit is not presented as a reduction of income tax expense.

Because the credit is taxable (even if an entity is in an overall loss position), the credit has the economic effect of providing a benefit to the recipient equal to the amount net of the withholding. Accordingly, while we believe the credit generally should be presented gross in the income statement (with the related tax in income tax expense), it is also acceptable for an entity to present the credit net of the withholding in pretax income. This accounting policy election should be consistently applied.



Example 2.3.20

UK Research and Development Expenditure Credit

ABC Corp, a UK based corporation, invests £10,000,000 developing an innovative tempering process in Year 1. The expenditure is eligible for the RDEC. The RDEC entitles ABC to a gross credit of 13% of qualifying R&D expenditures.

The credit may offset ABC's corporation tax liability or its employee withholding taxes, or it may become refundable to ABC under certain circumstances. The amount of credit that is refunded is net of tax, but the notional tax incurred creates a nonrefundable tax credit carryforward.

In Year 1, ABC records a pretax loss of £2,500,000, excluding the impact of the credit. ABC had no permanent or temporary differences but needs a valuation allowance against any deferred tax assets. The tax rate is 25%.

ABC can record the credit either gross or net in its pretax loss.

Outcome (£)	Gross	Net
Pretax loss exclusive of RDEC	(2,500,000)	(2,500,000)
RDEC credit	1,300,000 ¹	975,000 ²
Total pretax loss	(1,200,000)	(1,525,000)
Current tax expense	325,000	0
Deferred tax expense (benefit)	0 ³	0 ³
Income tax expense	325,000	0
Net income	(1,525,000)	(1,525,000)
Notes:		
1. £10,000,000 qualifying expenditures × 13% RDEC.		
2. When presenting net, the £1,300,000 less the 25% withholding, or £975,000, is recorded in pretax loss.		
3. Although there is a deferred tax asset carryforward for £325,000 withholding, the deferred tax expense/benefit is £0 for both columns because ABC needs a valuation allowance against its deferred tax assets.		

3. Transferable credits

Detailed contents

3.1 How the standard works

3.2 Accounting for transferable credits

- 3.2.10 Accounting for the generation of refundable, transferable credits
- 3.2.20 Accounting for the generation of nonrefundable, transferable credits
- 3.2.30 Accounting for the transfer (sale) of the credit
- 3.2.40 Accounting for the purchase of the credit

Examples

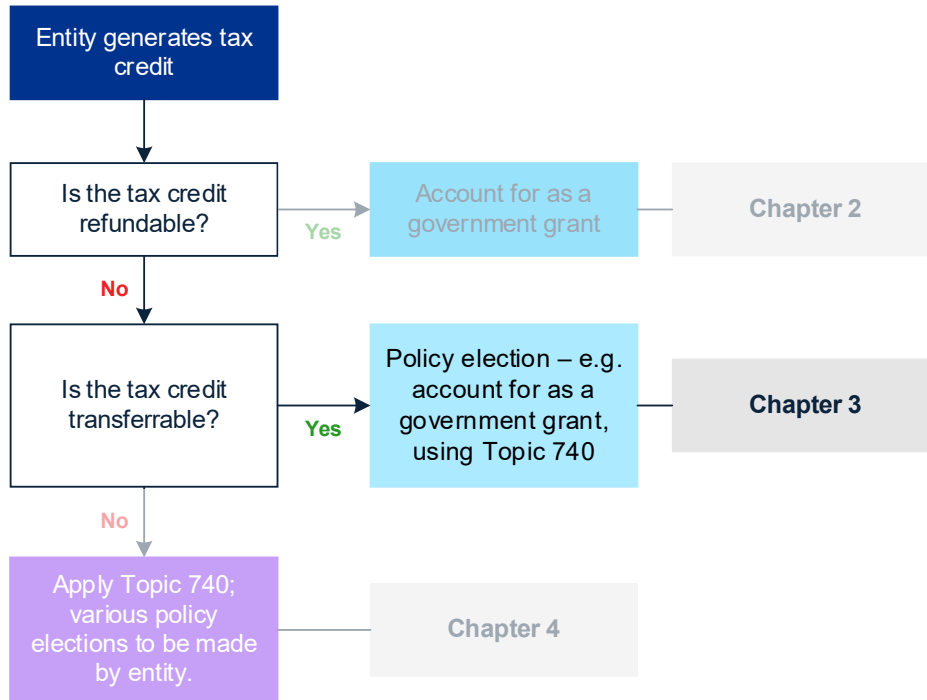
- 3.2.10 Transferable tax credits, sold to third party – ASC 740 (flow-through method)
- 3.2.20 Transferable tax credits, sold to third party – ASC 740 (deferral method)
- 3.2.30 Transferable tax credits, offsets income tax liability – Government grant accounting (IAS 20)
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3.3 Other application issues

- 3.3.10 Inflation Reduction Act
- 3.3.20 Standalone reporting considerations for a partnership under ASC 740
- 3.3.30 Statement of cash flows presentation

3.1 How the standard works

This chapter addresses the accounting for transferable tax credits.



Certain jurisdictions allow an entity to make a one-time transfer of an income tax credit (or portions of the credit) to another unrelated taxpayer (the acquirer) in exchange for cash; in many of those jurisdictions, the credit is nonrefundable and nontransferable to the acquirer. We expect the acquirer to generally purchase the credit at a discount to its full tax value.

US GAAP does not specifically address how the transferability feature in credits affects the accounting for the generation or sale of those credits.

The following table summarizes approaches we believe are acceptable to account for transferrable credits by the reporting entity.

Transaction	Refundable	Nonrefundable
Generation of transferable credit	Apply government grant accounting models by analogy	Acceptable approaches to accounting include: <ul style="list-style-type: none"> • Topic 740 (income taxes) model • government grant model • intent-based model (in certain circumstances)
Transfer (sale) of transferable credit	Topic 860 (transfers of financial assets) may	Subtopic 610-20 (sales of nonfinancial assets) may

3. Transferable credits

Transaction	Refundable	Nonrefundable
	apply, but facts and circumstances determine appropriate model	apply, but facts and circumstances determine appropriate model
Purchase of transferable credit that is nonrefundable, nontransferable to the acquirer	Topic 740 applies	Topic 740 applies

The policy choices should be consistently applied to transferable tax credits, as discussed in Topic 250 (accounting changes); see section 3.3 of KPMG Handbook, [Accounting changes and error corrections](#).

3.2 Accounting for transferable credits

3.2.10 Accounting for the generation of refundable, transferable credits

We believe refundable tax credits are government grants, even if they are also transferable. This is because the taxpayer can realize the benefit regardless of whether it has an income tax liability. [Section 2.2](#) addresses the initial recognition and measurement for both transferable and nontransferable refundable credits.

If an entity elects to transfer the credit to a third party rather than make a direct pay election (this scenario is expected to be uncommon), the entity evaluates whether the asset is impaired if the credit is expected to be sold at a discount and derecognizes the credit on transfer under the guidance included in [section 3.2.30](#).

3.2.20 Accounting for the generation of nonrefundable, transferable credits

Based on discussions with the FASB staff, we believe there is more than one acceptable approach.

Topic 740

We believe it is most appropriate for entities to apply Topic 740 to nonrefundable, transferable credits. Under Topic 740, the accounting for these credits depends on the nature of the credit.

- **PTCs and other current year activity-based credits:** An entity recognizes the benefit in income tax expense (benefit) in the year the credit arises.
- **ITCs:** An entity has a policy choice when accounting for ITCs. The flow-through method recognizes the ITC benefit when it arises; the deferral method initially defers the ITC benefit and recognizes it over the productive life of the underlying asset.

[Section 4.2](#) addresses the accounting for tax credits under Topic 740.

In applying Topic 740, we believe an entity may either consider or disregard expected transfers of the credits in assessing their realizability as part of the valuation allowance analysis.

The accounting for the generation of the credit using Topic 740 is illustrated in [Examples 3.2.10](#) and [3.2.20](#).

Government grant (IAS 20)

A second approach is a government grant model. We believe it is acceptable for entities to elect a policy to account for the credits as government grants (outside

the scope of Topic 740). However, entities making this election should consider how future standard-setting on the accounting for government grants could impact their accounting. [Section 2.1](#) further discusses the project on the FASB's research agenda to consider incorporating into US GAAP the recognition, measurement and presentation guidance on accounting for government grants in IAS 20.

The recognition and presentation of government grants using IAS 20 is discussed in [section 2.2.10](#).

Measurement

If an entity intends, and has the ability, to use the tax credit to reduce its income tax liability, we believe the tax credit is generally monetary in nature because the tax credit is a fixed or determinable amount and is expected to reduce the entity's tax liability (which is a monetary liability). However, if the entity intends to sell the tax credit to a third party, we believe the tax credit is generally a nonmonetary asset because the amount to be realized for the tax credit is not fixed or determinable.

For a government grant in the form of a nonmonetary asset, an entity makes a policy election to recognize the grant at either the fair value of the nonmonetary asset or the nominal amount paid (nominal value). For a transferable tax credit, we would expect the nominal value to be \$0.

Although there is a policy choice, we believe entities should consult with their accounting advisers, auditors and potentially the SEC staff before concluding that it is appropriate to account for the transferable credit at the nominal value. This is because fair value is noted in IAS 20 as the usual approach. [\[IAS 20.23\]](#)

Intended use of credit	General nature of credit	Measurement
Using the credit	Monetary	The amount of the credit.
Selling the credit	Nonmonetary	Fair value - the price that would be received upon the sale of the transferable credit in an orderly transaction between market participants at the measurement date.

The accounting for the generation of the credit using government grant accounting is illustrated in [Examples 3.2.30](#) and [3.2.40](#).

Intent-based

A third approach is an intent-based model whereby an entity accounts for the credit based on how it expects to monetize the credit. However, before concluding that its use is appropriate for transferable credits, we believe entities should consult with their accounting advisers, auditors and potentially the SEC staff.

Under this approach:

- if an entity expects to use a credit to offset its income tax liability, it accounts for the credit under Topic 740 (see [section 4.2](#)); or

- if an entity expects to transfer a credit, it accounts for the credit as a government grant, outside of income taxes (see [section 2.2](#)).

3.2.30 Accounting for the transfer (sale) of the credit

When an entity sells a transferable credit, it determines the appropriate accounting guidance to apply to the sale based on the facts and circumstances. For example, if the credit is nonrefundable, it may be appropriate to consider the derecognition guidance in Subtopic 610-20 (sales of nonfinancial assets). However, if the credit is refundable, Topic 860 (transfers of financial assets) may apply.

Derecognition of nonrefundable credits (Subtopic 610-20)

Subtopic 610-20 provides a model for recognizing a gain or loss on the transfer of nonfinancial assets to noncustomers. An entity applies the guidance in Topic 606 (with incremental guidance from Subtopic 610-20) to determine when to derecognize the nonrefundable credit and the amount of the gain or loss.

If an entity applies Topic 740 in accounting for the generation of the credit and elects to consider expected transfers of the credits in assessing their realizability as part of the valuation allowance analysis, it does not recognize a gain or loss on sale. Instead, an entity recognizes changes in the estimated proceeds as an adjustment to its valuation allowance.

See chapter 17 in KPMG Handbook, [Revenue recognition](#), for further discussion on accounting for the derecognition of nonfinancial assets.

Derecognition of refundable credits (Topic 860)

Topic 860 addresses the accounting by both the transferor and transferee for a transfer to which sale accounting applies. An entity accounts for the transfer (sale) of the refundable credit as follows.

- Derecognizes the financial asset.
- Recognizes all assets obtained and liabilities incurred in the sale at fair value.
- Recognizes a gain or loss on sale.

See KPMG Handbook, [Transfers and servicing of financial assets](#), for further discussion on accounting for the transfer of financial assets.


Presentation

If an entity sells a credit, it recognizes the sale proceeds, derecognizes the carrying amount of the transferable credit, and recognizes the gain or loss. If accounting for the credits under Topic 740, we believe it is most appropriate for entities to recognize the gain or loss in income tax expense or benefit.

We also believe it is acceptable for entities applying Topic 740 to the credits to recognize the gain or loss on sale of the credits in pretax income or loss.

We believe entities accounting for the credits as government grants outside the scope of Topic 740 would recognize the gain or loss on sale of the credits in pretax income or loss.

The accounting for the transfer of a credit is illustrated in [Examples 3.2.10](#), [3.2.20](#) and [3.2.40](#).



Example 3.2.10

Transferable tax credits, sold to third party – ASC 740
(flow-through method)

Background

ABC Corp operates in Country X, which provides an ITC equal to 6% of the basis of certain qualifying assets placed in service during the year (in this case, a solar energy facility). A taxpayer must apply for an allocation of the credit, subject to the discretion of the taxing authority, to generate the credit.

The credit is transferable at ABC’s election; no direct pay election is available. The ITC is nontaxable and ABC must reduce its tax basis in the property by 100% of the credit amount. The credits can offset 75% of an entity’s tax liability.

Other information

The solar energy facility will be depreciated for financial statement and income tax purposes on a straight-line basis over five years.

The income tax rate in Country X is 21%.

Policy elections

ABC elects to apply Topic 740 to nonrefundable, transferable credits and the flow-through method to account for ITCs.

Year 1

In Year 1, ABC applies for and receives an allocation of credits for the construction of a solar energy facility. It incurs \$50,000,000 of qualifying construction costs, which will generate a tax credit of \$3,000,000 (6% of eligible capitalized costs) when the facility is placed in service.

ABC records the following journal entries in Year 1.

	<i>Debit</i>	<i>Credit</i>
CIP	50,000,000	
Cash		50,000,000
<i>To recognize the costs incurred for the construction of the qualifying asset.</i>		

Year 2

On January 1, Year 2, ABC places the facility in service and generates a tax credit of \$3,000,000 (6% of eligible capitalized costs). ABC expects to use the entire tax credit to offset its income tax liability.

ABC's Year 2 tax liability before applying the tax credit is \$2,500,000, 75% of which can be offset by tax credits. Accordingly, ABC will use \$1,875,000 of the \$3,000,000 in tax credits.

ABC records the following journal entries on January 1, Year 2.

	<i>Debit</i>	<i>Credit</i>
PPE CIP <i>To recognize that the qualifying asset was placed in service.</i>	50,000,000	50,000,000
Income taxes payable ¹ Current tax benefit <i>To recognize the credit used in Year 2.</i>	1,875,000	1,875,000
Deferred tax asset ¹ Deferred tax benefit <i>To recognize the benefit of the remaining credit expected to be used in future years.</i>	1,125,000	1,125,000
Note:		
1. In Year 2, ABC uses \$1,875,000 of the \$3,000,000 in tax credits. The \$1,875,000 used during the year reduces income taxes payable. The remaining tax credit of \$1,125,000 is available to reduce future tax liabilities and therefore is recorded as a deferred tax asset.		

At the end of Year 2, Management revises its future income projections and now expects taxable losses for Year 3 resulting from bonus depreciation on capital improvements (for an unrelated asset). ABC expects to return to taxable income in subsequent years. As a result of the change, Management expects to sell the remaining tax credit for \$1,035,000 (92% of face value) to a third party in Year 3 and elects to make a portion of the credit transferable.

ABC elects to consider the expected transfer of the credit in assessing its realizability as part of the valuation allowance analysis (policy election).

ABC records the following journal entries in Year 2.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense PPE (accumulated depreciation) <i>To recognize the depreciation expense.</i>	10,000,000	10,000,000
Income taxes payable ¹ Current tax benefit <i>To recognize the benefit of tax depreciation to be taken on the Year 2 tax return.</i>	1,974,000	1,974,000

3. Transferable credits

	<i>Debit</i>	<i>Credit</i>
Deferred tax expense	504,000	
Deferred tax liability ² <i>To recognize the deferred tax liability related to the facility.</i>		504,000
Deferred tax benefit	90,000	
DTA – Valuation allowance ³ <i>To recognize the valuation allowance</i>		90,000
Notes:		
<ol style="list-style-type: none"> 1. Tax basis of \$47,000,000 (\$50,000,000 cost, less \$3,000,000 of tax credits generated) over five years results in tax depreciation of \$9,400,000 × 21%. 2. A deferred tax liability is recognized for the difference between the financial statement carrying amount and the tax basis of the acquired asset (((\$40,000,000 – \$37,600,000) × 21%). 3. The DTA – valuation allowance is the difference between the remaining tax credit available of \$1,125,000 and the expected proceeds from the sale of the credits of \$1,035,000 (\$1,125,000 × 92%). None of the deferred tax liability would support recognition of the deferred tax asset because it is expected to be transferred. 		

Year 3


During Year 3, ABC sells the remaining credit for \$1,012,500 (90% of face value) to a third party. The sale qualifies for derecognition under Subtopic 610-20.

ABC records the following journal entries in Year 3.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense	10,000,000	
PPE (accumulated depreciation) <i>To recognize the depreciation expense.</i>		10,000,000
Deferred tax asset – net operating loss carryforward ¹	1,974,000	
Deferred tax benefit <i>To recognize the tax benefit of depreciation.</i>		1,974,000
Deferred tax liability	126,000	
Deferred tax benefit <i>To recognize the reduction of the deferred tax liability related to the facility.</i>		126,000
Deferred tax expense ²	22,500	
DTA – Valuation allowance <i>To adjust the valuation allowance to the revised expected proceeds prior to the sale.</i>		22,500
Cash	1,012,500	
DTA – Valuation allowance	112,500	
Deferred tax asset <i>To recognize the sale of the credits to a third party.</i>		1,125,000

Notes:

1. Tax depreciation of \$9,400,000 × 21%.
2. The difference between the carrying value of the remaining tax credit of \$1,035,000 and the expected proceeds from the sale of the credits of \$1,012,500.



Example 3.2.20

Transferable tax credits, sold to third party – ASC 740 (deferral method)

Background

ABC Corp operates in Country X, which provides an ITC equal to 6% of the basis of certain qualifying assets placed in service during the year (in this case, a solar energy facility). A taxpayer must apply for an allocation of the credit, subject to the discretion of the taxing authority, to generate the credit.

The credit is transferable at ABC’s election; no direct pay election is available. The ITC is nontaxable and ABC must reduce its tax basis in the property by 100% of the credit amount. The credits can offset 75% of an entity’s tax liability.

Other information

The solar energy facility will be depreciated for financial statement and income tax purposes on a straight-line basis over five years.

The income tax rate in Country X is 21%.

Policy elections

ABC elects to apply Topic 740 to nonrefundable, transferable credits. ABC also applies the deferral method (policy choice 1) to account for investment tax credits. ABC has elected the following policy choices under the deferral method (see [section 4.2.20](#) for further discussion of the policy choices):

Step	Policy choice
Initially defer the ITC benefit	Reduce carrying amount of asset (policy choice 2)
Recognize the deferred ITC benefit over the productive life of the qualifying property	Depreciation expense (policy choice 4)

Year 1

In Year 1, ABC applies for and receives an allocation of credits for the construction of a solar energy facility. It incurs \$50,000,000 of qualifying construction costs, which will generate a tax credit of \$3,000,000 (6% of eligible capitalized costs) when the facility is placed in service.

3. Transferable credits

ABC records the following journal entry in Year 1.

	<i>Debit</i>	<i>Credit</i>
CIP	50,000,000	
Cash		50,000,000
<i>To recognize the costs incurred for the construction of the qualifying asset.</i>		

Year 2

On January 1, Year 2, ABC places the facility in service and generates a tax credit of \$3,000,000 (6% of eligible capitalized costs). ABC expects to use the entire tax credit to offset its income tax liability.

ABC's Year 2 tax liability before applying the tax credit is \$2,500,000, 75% of which can be offset by tax credits. Accordingly, ABC will use \$1,875,000 of the \$3,000,000 in tax credits.

ABC records the following journal entries on January 1, Year 2.

	<i>Debit</i>	<i>Credit</i>
PPE	50,000,000	
CIP		50,000,000
<i>To recognize that the qualifying asset was placed in service.</i>		
Deferred tax asset	3,000,000	
PPE		3,000,000
<i>To initially defer the ITC (policy choice 2).</i>		

At the end of Year 2, Management revises its future income projections and now expects taxable losses for Year 3 resulting from bonus depreciation on capital improvements (for an unrelated asset). ABC expects to return to taxable income in subsequent years. As a result of the change, Management expects to sell the remaining tax credit for \$1,035,000 (92% of face value) to a third party in Year 3 and elects to make a portion of the credit transferable.

ABC elects to consider the expected transfers of the credits in assessing their realizability as part of the valuation allowance analysis (policy election).

ABC records the following journal entries in Year 2.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense ¹	9,400,000	
PPE (accumulated depreciation)		9,400,000
<i>To recognize the depreciation expense.</i>		
Income taxes payable ²	1,974,000	
Current tax benefit		1,974,000
<i>To recognize the benefit of tax depreciation to be taken on the Year 2 tax return.</i>		

3. Transferable credits

	<i>Debit</i>	<i>Credit</i>
Income taxes payable	1,875,000	
Deferred tax expense	1,875,000	
Current tax benefit		1,875,000
Deferred tax asset		1,875,000
<i>To recognize the utilization of part of the ITC.</i>		
Deferred tax expense	90,000	
DTA – Valuation allowance ³		90,000
<i>To recognize a valuation allowance after the generation of the credit on the remaining tax credit, considering the proceeds from the sale of the credit.</i>		
Notes:		
1. [$\$50,000,000$ qualifying asset – $\$3,000,000$ tax credit] \div 5 years.		
2. Tax depreciation of $\$9,400,000 \times 21\%$.		
3. The DTA – valuation allowance is the difference between the remaining tax credit available of $\$1,125,000$ and the expected proceeds from the sale of the credits of $\$1,035,000$ ($\$1,125,000 \times 92\%$).		


Year 3

During Year 3, ABC sells the remaining credit for \$1,012,500 (90% of face value) to a third party. The sale qualifies for derecognition in accordance with Subtopic 610-20.

ABC records the following journal entries in Year 3.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense ¹	9,400,000	
PPE (accumulated depreciation)		9,400,000
<i>To recognize the depreciation expense.</i>		
Deferred tax asset – net operating loss carryforward ²	1,974,000	
Deferred tax benefit		1,974,000
<i>To recognize the tax benefit of depreciation.</i>		
Deferred tax expense ³	22,500	
DTA – Valuation allowance		22,500
<i>To adjust the valuation allowance to the revised expected proceeds prior to the sale.</i>		
Cash	1,012,500	
DTA – Valuation allowance	112,500	
Deferred tax asset		1,125,000
<i>To recognize the sale of the credits to a third party.</i>		
Notes:		
1. [$\$50,000,000$ qualifying asset – $\$3,000,000$ tax credit] \div 5 years.		
2. Tax depreciation of $\$9,400,000 \times 21\%$.		

3. The difference between the carrying value of the remaining tax credit of \$1,035,000 and the expected proceeds from the sale of the credit of \$1,012,500.



Example 3.2.30

Transferable tax credits, offsets income tax liability – Government grant accounting (IAS 20)

Background

ABC Corp operates in Country X, which provides an investment credit equal to 6% of the basis of certain qualifying assets placed in service during the year (in this case, a solar energy facility). A taxpayer must apply for an allocation of the credit, subject to the discretion of the taxing authority, to generate the credit.

The credit is transferable at ABC's election; no direct pay election is available. The credit is nontaxable and ABC must reduce its tax basis in the property by 100% of the credit amount. The credits can offset up to 75% of an entity's tax liability.

Other information

The solar energy facility will be depreciated for financial statement and income tax purposes on a straight-line basis over five years.

The income tax rate in Country X is 21%.

Although the credit is transferable, ABC does not expect to transfer it to a third party and will use the credit to offset its tax liability.

Policy election

ABC elects to apply government grant accounting to nonrefundable, transferable credits. It has an existing policy to account for government grants by analogy to IAS 20 and to present the credit as a reduction of the cost of the asset. Based on these policy elections, the benefit of the credit is recognized in profit or loss through a reduction of depreciation expense.

Year 1

In Year 1, ABC applies for and receives an allocation of a credit for the construction of a solar energy facility. It incurs \$50,000,000 of qualifying construction costs, which will generate a credit of \$3,000,000 (6% of eligible capitalized costs) when the facility is placed in service.

ABC determines it is probable that (1) it will comply with the credit's relevant conditions and (2) the credit will be received.

ABC considers the future reduction in tax basis of \$3,000,000 that would occur upon placing the facility in service and concludes that no temporary difference existed as of the end of Year 1.

3. Transferable credits

ABC records the following journal entries in Year 1.

	<i>Debit</i>	<i>Credit</i>
CIP Cash <i>To recognize the costs incurred for the construction of the qualifying asset.</i>	50,000,000	50,000,000
Other asset ² CIP <i>To recognize the investment credit (net presentation).</i>	3,000,000 ¹	3,000,000
Notes:		
1. ABC concludes the credit is a monetary asset and measures it at the full credit amount.		
2. ABC recognizes an 'other asset' based on its policy election to account for the credit as a government grant. Because there is no tax consequence when the carrying amount of the other asset is recovered, ABC concludes no deferred tax should be recognized.		

Year 2

On January 1, Year 2, ABC places the facility in service and the credit becomes available for use on the tax return.

ABC's tax liability before applying the credit is \$2,500,000, 75% of which can be offset by credits. Accordingly, in Year 2, ABC will use \$1,875,000 of the \$3,000,000 credit.

ABC records the following journal entry on January 1, Year 2.

	<i>Debit</i>	<i>Credit</i>
PPE CIP <i>To recognize that the qualifying asset was placed in service.</i>	47,000,000	47,000,000

ABC records the following journal entries in Year 2.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense ¹ PPE (accumulated depreciation) <i>To recognize the depreciation expense.</i>	9,400,000	9,400,000
Income taxes payable ² Current tax benefit <i>To recognize the tax benefit of tax depreciation to be taken on the Year 2 tax return.</i>	1,974,000	1,974,000
Income taxes payable ³ Other asset <i>To recognize the credit used during Year 2.</i>	1,875,000	1,875,000

Notes:

1. $[\$50,000,000 \text{ qualifying asset} - \$3,000,000 \text{ credit}] \div 5 \text{ years}$.
2. Tax depreciation of $\$9,400,000$ $[\$47,000,000 \text{ tax basis} \div 5 \text{ years}] \times 21\%$.
3. The credit can only be used to offset 75% of the $\$2,500,000$ tax liability.

Year 3

In Year 3, ABC's tax liability before applying the credit is $\$2,000,000$. Accordingly, in Year 2, ABC uses the remaining $\$1,125,000$ of the $\$3,000,000$ credit.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense	9,400,000	
PPE (accumulated depreciation)		9,400,000
<i>To recognize the depreciation expense.</i>		
Income taxes payable	1,974,000	
Current tax benefit		1,974,000
<i>To recognize the benefit of tax depreciation to be taken on the Year 3 tax return.</i>		
Income taxes payable ¹	1,125,000	
Other asset		1,125,000
<i>To recognize the credit used during Year 3.</i>		
Note:		
1. ABC uses the remaining available credit of $\$1,125,000$ to offset its tax liability.		

**Example 3.2.40****Transferable tax credits, sold to third party – Government grant accounting (IAS 20)****Background**

ABC Corp operates in Country X, which provides an investment credit equal to 6% of the basis of certain qualifying assets placed in service during the year (in this case a solar energy facility). A taxpayer must apply for an allocation of the credit, subject to the discretion of the taxing authority, to generate the credit.

The credit is transferable at ABC's election; no direct pay election is available. The credit is nontaxable and ABC must reduce its tax basis in the property by 100% of the credit amount. The credit can offset up to 75% of an entity's tax liability.

Other information

The solar energy facility will be depreciated for financial statement and income tax purposes on a straight-line basis over five years.

The income tax rate in Country X is 21%.

ABC intends to sell the credit to a third party and estimates its fair value is 90% of the credit amount.

Policy elections

ABC elects to apply government grant accounting to nonrefundable, transferable credits. It has an existing policy to account for government grants by analogy to IAS 20, to present the credit as a reduction of the cost of the asset, and to measure government grants of nonmonetary assets at fair value. Based on these policy elections, the benefit of the grant is recognized in profit or loss through reduced depreciation expense.

Year 1

In Year 1, ABC applies for and receives an allocation of a credit for the construction of a solar energy facility. It incurs \$50,000,000 of qualifying construction costs, which will generate a credit of \$3,000,000 (6% of eligible capitalized costs) when the facility is placed in service.

ABC determines it is probable that (1) it will comply with the credit's relevant conditions and (2) the credit will be received.

ABC considers the future reduction in tax basis of \$3,000,000 that would occur upon placing the facility in service and concludes that no temporary difference existed as of the end of Year 1.

ABC records the following journal entry in Year 1.

	<i>Debit</i>	<i>Credit</i>
CIP	50,000,000	
Cash		50,000,000
<i>To recognize the costs incurred for the construction of the qualifying asset.</i>		
Other asset ²	2,700,000 ¹	
CIP		2,700,000
<i>To recognize the investment credit (net presentation).</i>		
CIP	79,747 ³	
Deferred tax liability		79,747
<i>To recognize the temporary difference between the book basis of \$47,300,000 and the tax basis of \$47,000,000 of the qualifying asset.</i>		
Notes:		
1. ABC concludes the credit is a nonmonetary asset and measures it at its fair value, which represents the price at which ABC would expect to sell in an orderly transaction between market participants. \$3,000,000 x 90%.		
2. ABC recognizes an other asset based on its policy election to account for the credit as a government grant.		
3. The deferred tax effect and corresponding adjustment to the initial carrying amount of the asset is calculated using the simultaneous equation. This calculation is explained more fully in KPMG Handbook, Accounting for income taxes (from paragraph 10.001).		
$(21\% \div (1 - 21\%)) \times (\$47,000,000 - \$47,300,000) = \$79,747$		

Year 2

On January 1, Year 2, ABC places the facility in service and the credit becomes available for use on the tax return.

During Year 2, ABC sells the credit for \$2,760,000 (92% of the credit value) to a third party. The sale qualifies for derecognition under Subtopic 610-20.

ABC records the following journal entry on January 1, Year 2.

	<i>Debit</i>	<i>Credit</i>
PPE ¹	47,379,747	
CIP		47,379,747
<i>To recognize that the qualifying asset was placed in service.</i>		
Note:		
1. [\$50,000,000 of qualifying costs – \$2,700,000 of credits + \$79,747 resulting from the simultaneous equation in Year 1].		

ABC records the following journal entries in Year 2.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense ¹	9,475,949	
PPE (accumulated depreciation)		9,475,949
<i>To recognize the depreciation expense.</i>		
Income taxes payable ²	1,974,000	
Current tax benefit		1,974,000
<i>To recognize the benefit of tax depreciation to be taken on the Year 2 tax return.</i>		
Deferred tax liability ³	15,949	
Deferred tax benefit		15,949
<i>To recognize change in deferred taxes.</i>		
Cash	2,760,000	
Other asset		2,700,000
Other income ⁴		60,000
<i>To recognize the sale of the credit to a third party and the related gain.</i>		
Notes:		
1. [\$50,000,000 qualifying asset – \$2,700,000 credit + \$79,747] ÷ 5 years.		
2. Tax depreciation of \$9,400,000 [\$47,000,000 tax basis ÷ 5 years] × 21%.		
3. The change in deferred taxes is the end-of-year deferred tax liability (\$63,707) minus the beginning-of-year deferred tax liability (\$79,747).		
4. Represents the difference between the carrying amount of the credit of \$2,700,000 and proceeds from the sale of \$2,760,000.		

3.2.40 Accounting for the purchase of the credit

An entity that acquires a credit may do so at a price that is discounted from the credit amount. In practice, most transferable credits can only be transferred once. If the acquirer can only use it to offset its income tax liability, we believe it recognizes the acquired credit as a deferred tax asset and measures it under Topic 740. The difference between the purchase price and the Topic 740 measurement of the acquired credit is recognized as a deferred credit. The deferred credit is recognized in income tax expense in proportion to the reversal of the associated deferred tax asset. Reversal of the deferred credit is generally included in determining the entity's estimated annual effective tax rate unless it is acquired in an annual period after the tax year in which it is utilized.

The accounting for the purchase of the credit is illustrated in [Example 3.2.50](#).



Example 3.2.50 Purchase of tax credits

This is a continuation from [Example 3.2.40](#).

During the second quarter of Year 2, XYZ Corp purchases a \$3,000,000 tax credit from ABC Corp for \$2,760,000. XYZ can only use the credit to offset its income taxes because this tax credit is only eligible to be transferred once.

Scenario 1: Entire credit expected to be used in year of purchase

At the time of the purchase, XYZ forecasts it will use the entire credit on its Year 2 return and recognizes the following:

- \$3,000,000 credit as a reduction to its Year 2 income taxes payable; and
- \$240,000 discount as a decrease to its estimated annual income tax expense for purposes of computing its estimated annual effective tax rate.

Scenario 2: Entire credit not expected to be used in year of purchase

If XYZ expects to use only \$2,000,000 of the credit in Year 2, it recognizes the following:

- \$2,000,000 of the credit as a reduction to its Year 2 income taxes payable;
- \$1,000,000 of the credit as an increase to deferred tax assets;
- \$160,000 ($(\$2,000,000 \div \$3,000,000) \times \$240,000$) of the discount as a decrease to its estimated annual income tax expense for purposes of computing its estimated annual effective tax rate; and
- \$80,000 ($(\$1,000,000 \div \$3,000,000) \times \$240,000$) of the discount as a deferred credit that will be recognized in income tax expense in proportion to the reversal of the \$1,000,000 deferred tax asset.

3.3 Other application issues

3.3.10 Inflation Reduction Act

The IRA introduced certain credits with a transferability election for the first time at the US federal level. Under the legislation, each credit can only be transferred once, and the acquiring taxpayer can use the credit to offset its income taxes. The resulting payment is excluded from the selling taxpayer's taxable income.

For certain of the credits available under the IRA, there are also increased and bonus credits available for meeting prevailing wage, apprenticeship, and domestic content requirements. [Section 2.3.10](#) discusses the requirements in further detail. Entities may need to consider whether the ongoing requirements associated with increased and bonus credits available affect the recognition of the sale or income from the sale of those credits.

Certain credits have the transfer election for a specified period. For credits that arise in periods in which the transfer election is not available, an entity should account for the credit as nontransferable.

3.3.20 Stand-alone reporting considerations for a partnership under ASC 740

Partnerships or other pass-through entities (e.g. limited liability companies taxed as partnerships or subchapter S Corporations) are not directly subject to income taxes in many tax jurisdictions. If an entity is not subject to income taxes directly, differences between the financial statement carrying amounts and tax bases of assets and liabilities are not temporary differences because there are no future tax consequences to the entity. Accordingly, the stand-alone financial statements of such entities generally do not present deferred tax assets, deferred tax liabilities, or income tax expense related to those tax jurisdictions. Because these entities are not subject to income taxes directly, questions arise as to how to account for their nonrefundable, transferable credits.

A partnership or other pass-through entity has a policy choice to account for nonrefundable, transferable credits as government grants or using Topic 740. If the entity elects a government grant model, it recognizes the credit in pretax income as further described in [sections 2.2.10](#) and [3.2.20](#).

However, if the entity applies Topic 740, we believe there should be no income tax impact in continuing operations because the entity is a pass-through entity and is not subject to income taxes. Any income tax credits generated by the partnership are viewed as income tax benefits and are attributable to the investors. When a credit is sold and cash is received, we believe the entity should recognize any benefit of the credit in equity as it is a tax benefit attributable to the investors.

3.3.30 Statement of cash flows presentation

The cash inflow for the entity that generates the transferable credits is presented in the operating activities section of the statement of cash flows regardless of whether:

- ASC 740 or grant accounting is elected as the accounting policy; or
- the tax credit is used by the entity or transferred to a third party.

4. Nonrefundable, nontransferable tax credits

Detailed contents

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4.2.10 ITC – Flow-through method

4.2.20 ITC with tax basis reduction – Flow-through method

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4.3 Other application issues

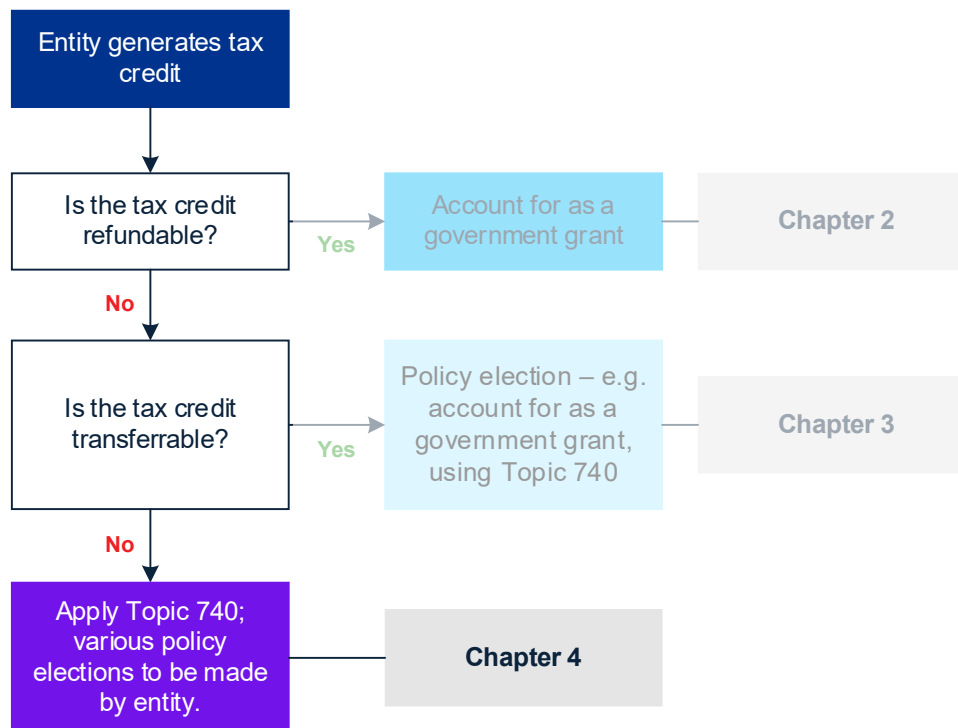
4.3.10 Inflation Reduction Act and CHIPS and Science Act

4.3.20 Interim period tax calculations

4.3.30 Sponsors of tax credit structures

4.1 How the standard works

This chapter addresses the accounting for nonrefundable, nontransferable tax credits.



Until the enactment of the IRA and CHIPS Act legislation in 2022, US federal tax credits have generally been both nonrefundable and nontransferable. When we discuss nonrefundable, nontransferable tax credits we're referring to credits that are realizable only if the entity has a sufficient amount of income tax liability to utilize the credit. We believe nonrefundable, nontransferable tax credits are in the scope of Topic 740 because they only can be utilized against an income tax liability.

A credit arises in the year it becomes available to offset an entity's income tax liability on the tax return. Once a credit arises, the accounting depends on the type of tax credit.

4. Nonrefundable, nontransferable tax credits

The accounting for different types of tax credits when they are both nonrefundable and nontransferable is summarized in the following table.

Investment tax credits (ITCs)	<p>Owners of qualifying property that generate ITCs have several policy elections available and can report the tax benefits in a variety of ways, including any of the following:</p> <ul style="list-style-type: none"> • full tax benefit when the credit arises; • some tax benefit when the credit arises; or • no tax benefit in the year the credit arises.
Other tax credits¹	<p>The full income tax benefit of credits not related to the acquisition of an asset are generally recognized when the credit arises.</p>
<p>Note:</p> <p>1. Other credits include, but are not limited to, production tax credits, certain research and experimental credits, work opportunity credits, and foreign tax credits.</p>	

4.2 Accounting for nonrefundable, nontransferable credits

4.2.10 Overview

ITCs

We believe ITCs are an incentive for the acquisition of an asset that is in the form of a credit, not an exclusion or deduction from taxable income.

How ITCs are accounted for depends on whether they are refundable (see [chapter 2](#)) or transferable (see [chapter 3](#)). If they are neither refundable nor transferable, they are accounted for under Topic 740. Topic 740 provides a policy choice (policy choice 1) as to the method for recognizing the benefit of ITCs: the flow-through method or the deferral method. [\[740-10-25-45 – 25-46\]](#)

- Under the flow-through method, the entity recognizes the ITC benefit when it arises.
- Under the deferral method, the entity initially defers the ITC benefit and recognizes it over the productive life of the underlying asset or the compositive productive life of all depreciable assets that gave rise to the ITC. Topic 740 states that the deferral method is the preferable approach.

Policy choice 1 is the foundational policy choice and, if the deferral method is selected, is followed by a series of other policy choices as an entity takes the steps necessary to recognize the ITC over the life of the qualifying property. These additional policy choices are described in [section 4.2.30](#) and illustrated in [Example 4.2.30](#), which compares these policy choices.

An entity that owns property qualifying for an ITC recognizes and measures its asset under Topic 360 (PPE). Generally, this means the property is initially measured at cost and depreciated over its useful life. It is also evaluated for impairment, as necessary. There may be adjustments to the financial statement carrying amount of the asset based on certain policy elections under the deferral method. See Steps 1 and 2 in [section 4.2.30](#) for additional discussion of these adjustments.

Other tax credits

If a tax credit other than an ITC is in the scope of Topic 740, an entity recognizes its benefit in income tax expense (benefit) in the year it arises (i.e. the year in which it becomes available to offset the entity's income tax liability). This is typically the period in which the related activity the tax credit is trying to incentivize occurs (if the recognition and measurement principles in Topic 740 are met).

Credits subject to ongoing requirements

Certain tax credits may be subject to recapture or penalty if the entity does not continue to comply with specified requirements during a compliance period. To avoid a liability (or derecognition of an asset) for the recapture or a penalty related to a credit's ongoing requirements, we believe management has to expect to continue to comply with the requirements.

To determine whether it can recognize the credit in its financial statements, an entity applies Topic 740's recognition and measurement guidance on accounting for uncertainty in income taxes. Under that guidance, recognizing a credit on a tax return is considered a 'tax position'. The entity evaluates whether it is more likely than not to sustain the tax benefit of the credit based on the technical merits of that tax position. Meeting the more-likely-than-not threshold is a positive assertion by management that the entity is entitled to some level of economic benefit based on the conditions that exist and the information that is available at the reporting date.

To make this positive assertion, we believe management needs to demonstrate that the entity has met the more-likely-than-not recognition threshold based on its compliance with the requirements under the tax law at the reporting date.

If new information subsequently becomes available, management reevaluates its assertion that the entity is entitled to the credits. The entity derecognizes (or remeasures) the benefits of the position if on reevaluation management concludes that:

- the tax position is no longer more likely than not to be sustained based on new information (or a different amount is greater than 50% likely of being realized); or
- it no longer expects to comply with the requirements.

4.2.20 ITCs and other tax credits – flow-through method

When an entity accounts for tax credits other than ITCs or applies the flow-through method for ITCs, it recognizes the benefit in income tax expense (benefit) in the year the credit arises. If the credit arises on the tax return over multiple years, the amount reflected in income is based on the amount that arises during the current year. A deferred tax asset (net of valuation allowance) is recognized for unused credits arising in the current year that are available to offset an entity's income tax liability in future years. The entire tax benefit from the tax credit is presented as a reduction to income tax expense (not as a reduction to operating expense).

The flow-through method is illustrated in [Example 4.2.10](#) and [Example 4.2.20](#).

Considerations applying only to ITCs accounted for under the flow-through method

Deferred taxes are established for the difference between the financial statement carrying amount of an asset and its tax basis, if any, when the flow-through method is applied. A taxable temporary difference often exists when an ITC results in a reduction of the tax basis of the property. In that case, we believe the deferred tax expense associated with the related deferred tax liability is recognized immediately in income tax expense or a further adjustment to the financial statement carrying amount of the asset (i.e. property). If the entity elects to further adjust the financial statement carrying amount of the asset, the temporary difference will also change, and the calculation becomes circular. The entity solves for this circularity by using the 'simultaneous equation'.



Example 4.2.10 ITC – Flow-through method

ABC Corp operates in Country X, which provides ITCs for the development of certain renewable energy facilities. The ITC credit is 50% of the cost of qualified energy property placed in service. There is no limitation on how much of a given year's income taxes payable may be offset by the credit and unused credits can be carried over indefinitely, but not refunded. The tax rate in Country X is 21%.

On January 1, Year 1, ABC purchases qualified solar energy generation equipment for \$100,000 and immediately places it in service. The equipment will be depreciated for financial statement and income tax purposes on a straight-line basis over five years.

ABC receives \$100,000 tax basis in the equipment and an ITC of \$50,000 as a result of the purchase ($50\% \times \$100,000$ purchase price). ABC has no remaining obligation to earn the credit.

ABC elects the flow-through method (**policy choice 1**).

It records the following journal entries on January 1, Year 1.

	<i>Debit</i>	<i>Credit</i>
PPE	100,000	
Cash		100,000
<i>To recognize acquisition of qualifying asset.</i>		

4. Nonrefundable, nontransferable tax credits

	<i>Debit</i>	<i>Credit</i>
Income taxes payable	50,000	
Current tax benefit		50,000
<i>To recognize ITC benefit.¹</i>		
Note:		
1. There is no deferred tax asset at the beginning or end of year related to the PPE because the financial statement carrying amount equals its tax basis at both dates.		

ABC records the following journal entries during Year 1.

	<i>Debit</i>	<i>Credit</i>
Depr. expense ¹	20,000	
PPE (accum. depr)		20,000
<i>To recognize depreciation expense.</i>		
Income taxes payable	4,200	
Current tax benefit		4,200
<i>To recognize the tax benefit of depreciation.</i>		
Note:		
1. The financial statement carrying amount of the asset is depreciated by 20% each year.		

Effect on Year 1 financial statements (\$)			
Assets		Profit after tax	
PPE	80,000	Depr expense	20,000
Deferred tax asset	–	Income tax benefit	(54,200)
Cash	(100,000)	Net increase	(34,200)
Net decrease	(20,000)	Year 1 effective tax rate	271%
Liabilities		Years 2 to 5 effective tax rate ¹	21%
Income taxes payable	54,200		
Decrease	(54,200)		
Increase in net assets	34,200		

4. Nonrefundable, nontransferable tax credits

Note:

1. The income tax benefit (expense) used to compute the effective tax rate in Years 2 to 5 is the total for the year minus the effect recognized on January 1.



Example 4.2.20

ITC with tax basis reduction – Flow-through method

ABC Corp operates in Country X and receives from Country X an ITC for 50% of the purchase price of certain qualifying assets. The tax credit can be used to reduce up to 75% of the entity's income tax obligation of any given year and the tax basis of the property is reduced by the full amount of the credit (i.e. the credit is in lieu of otherwise available depreciation deductions for that portion of the purchase price of the asset). Unused credits can be carried forward to reduce a future period's income taxes payable. No valuation allowance is required on deferred tax assets. The tax rate in Country X is 21%.

On January 1, Year 1, ABC purchases \$100,000 of qualifying assets. The assets will be depreciated for financial statement and income tax purposes on a straight-line basis over five years. The tax basis of the assets purchased is \$50,000 (\$100,000 purchase price minus the \$50,000 available tax credit), and the financial statement carrying amount of the assets is \$100,000. ABC recognizes a deferred tax liability for the temporary difference.

In Year 1, ABC has financial statement income of \$60,000 before any income tax and depreciation expenses. ABC's financial statement pretax income after depreciation expense is \$40,000 (\$60,000 – (\$100,000 ÷ 5 years) book depreciation expense) and its taxable income after depreciation expense is \$50,000 (\$60,000 – (\$50,000 ÷ 5 years) tax depreciation expense). The difference between pretax financial statement income and the taxable income is the \$10,000 of additional depreciation expense for the excess \$50,000 carrying amount of qualifying assets for financial statement purposes over its tax basis. ABC has no other permanent or temporary differences.

ABC has no remaining obligation to earn the credit and elects the flow-through method (**policy choice 1**). It records the following journal entries on January 1, Year 1.

	<i>Debit</i>	<i>Credit</i>
PPE	100,000	
Cash		100,000
<i>To recognize acquisition of qualifying asset.</i>		

4. Nonrefundable, nontransferable tax credits

	<i>Debit</i>	<i>Credit</i>
Deferred tax asset ¹	50,000	
Deferred tax liability ²		10,500
Deferred tax benefit <i>To recognize ITC benefit.¹</i>		39,500
Notes:		
1. The deferred tax asset is the amount of the tax credit generated that is available to reduce current and future tax liabilities.		
2. A deferred tax liability is recognized for the difference between the financial statement carrying amount and the tax basis of the acquired asset ($(\$100,000 - \$50,000) \times 21\%$).		

ABC records the following journal entries during Year 1.

	<i>Debit</i>	<i>Credit</i>
Depreciation expense ¹	20,000	
PPE (accumulated depreciation) <i>To recognize depreciation expense.</i>		20,000
Current tax expense ²	2,625	
Income taxes payable <i>To recognize income taxes payable.</i>		2,625
Deferred tax liability ³	2,100	
Deferred tax expense ⁴	5,775	
Deferred tax assets ⁵ <i>To recognize ITC utilization.</i>		7,875
Notes:		
1. The financial statement carrying amount of the asset is depreciated by 20% each year.		
2. Total income taxes payable before considering the ITC is \$10,500 ($\$50,000 \times 21\%$). The maximum ITC that can be used for Year 1 is \$7,875 (75% of the current period income taxes payable) resulting in income taxes payable for Year 1 of \$2,625.		
3. The adjustment to the deferred tax liability for the acquired asset is the difference between the ending deferred tax liability of \$8,400 ($(\$80,000 \text{ financial statement carrying amount} - \$40,000 \text{ tax basis}) \times 21\%$) and the deferred tax liability immediately after acquisition of \$10,500.		
4. Deferred tax expense is the change in the net deferred tax assets and liabilities ($\$33,725 \text{ net deferred tax asset at December 31, Year 1} - \$39,500 \text{ net deferred tax asset at January 1,}$		

4. Nonrefundable, nontransferable tax credits

Year 1). The ending net deferred tax asset of \$33,725 consists of a deferred tax asset of \$42,125 for the remaining available ITC carryforward minus a deferred tax liability of \$8,400 related to the qualifying assets.

5. The ITC used in Year 1 is \$7,875 (75% of the current period income tax payable).

Effect on Year 1 financial statements (\$)			
Assets		Profit after tax	
PPE	80,000	EBITDA	60,000
Deferred tax asset/liability	33,725	Depr expense	(20,000)
Cash	(40,000)	Income tax benefit	31,100
Net increase	73,725	Net increase	71,100
Liabilities			
Income taxes payable	(2,625)	Year 1 effective tax rate	(78%)
Net increase	(2,625)	Years 2 to 5 effective tax rate	21%
Increase in net assets	71,100		

4.2.30 ITCs – deferral method

There are multiple steps to applying the deferral method, some of which have additional accounting policy choices. These steps are illustrated in the following table and described further below. The impact on the financial statements of each permutation is then described in [section 4.2.40](#) and illustrated in [Example 4.2.30](#).

4. Nonrefundable, nontransferable tax credits

Principle	The ITC benefits are deferred and recognized over the productive life of the qualifying property					
Step 1	Initially defer the ITC benefit					
Policy choice 2	Reduce carrying amount of asset (contra-asset)			Recognize deferred income (liability)		
	A			B		
Step 2	Recognize deferred taxes on the temporary difference that arises from initially deferring the ITC benefit					
Policy choice 3	Reduce carry. amt. of asset (contra-asset)	Immediately in inc. tax exp. (ben.)		Reduce carry. amt. of asset (contra-asset)	Immediately in inc. tax exp. (ben.)	
	A1	A2		B1	B2	
Step 3	Recognize the deferred ITC benefit over the productive life of the qualifying property					
Policy choice 4	Depr. expense	Inc. tax exp. (ben.)	Depr. expense	Inc. tax exp. (ben.)	No policy choice: Inc. tax exp. (ben.)	No policy choice: Inc. tax exp. (ben.)
	A1a¹	A1b	A2a	A2b	B1	B2
Step 4	N/A, this step does not apply to direct investments in qualifying property.					
Step 5	Adjust deferred taxes based on the temporary difference that exists at the reporting date					
Note:						
1. The final outcomes of applying the different policy choices correspond to the outcomes illustrated in Example 4.2.30 .						

Step 1: Initially defer the ITC benefit

Policy choice 2: An entity may present the deferral of the ITC benefit (net of valuation allowance) by either reducing the carrying amount of the asset (i.e. through a contra-asset account) or recognizing deferred income (i.e. a liability account). [740-10-45-27]

Step 2: Recognize deferred taxes on the temporary difference that arises from initially deferring the ITC benefit

Policy choice 3: We believe an entity may recognize the deferred tax effect that arises from deferring the ITC benefit (net of valuation allowance) by recognizing it immediately in income tax expense (benefit) or further adjusting the financial statement carrying amount of the asset.

If the entity elects to further adjust the financial statement carrying amount of the asset, the temporary difference will also change, and the calculation becomes circular. The entity solves for this circularity by using the 'simultaneous equation'. The simultaneous equation generates a corresponding adjustment to the financial statement carrying amount of the related asset when measuring deferred taxes. As a result, there is no immediate income statement recognition from

4. Nonrefundable, nontransferable tax credits

recording deferred taxes for the day one temporary difference. Deferred taxes should ultimately equal the applicable tax rate applied to the difference between the financial statement carrying amount and the tax basis.

The simultaneous equation is described in Topic 740 in the context of purchasing an asset with an existing temporary difference; see [section 2.2.10](#) for further discussion.

Step 3: Recognize the deferred ITC benefit over the productive life of the qualifying property

The benefit of the ITC is recognized ratably over either the productive life of the specific acquired property that gave rise to the ITC (i.e. the depreciable life for financial reporting purposes) or the composite productive life of all depreciable assets that gave rise to the ITC.

We generally do not believe it is appropriate for the entity to recognize the ITC benefit over the period it must hold the asset to avoid recapture of the tax credit or the depreciable life of the asset for income tax purposes because those periods do not represent the productive life of the property.

If the ITC arises on the tax return over multiple years, the amount reflected in income is based on an estimate of the total ITC to be generated for the asset over the asset's life. The presentation of the outcomes in Step 3 depends on the policy choice made in Step 1.

- Contra-asset in Step 1, **policy choice 4**: We believe an entity that defers the ITC benefit with a credit to the financial statement carrying amount of the asset may present the periodic benefit in income tax expense (benefit) or in depreciation expense.
- Deferred income in Step 1: An entity that defers the ITC benefit with a credit to deferred income presents the periodic benefit in income tax expense (benefit). There is no policy choice.

Step 4: N/A

This step does not apply to a direct investment in qualifying property. However, it is used here as a null step so that the steps to follow are consistent with the steps used for investors in tax credit structures (see [section 5.3.20](#)).

Step 5: Adjust deferred taxes based on the temporary difference that exists at the reporting date

In the final step, an entity adjusts its deferred taxes each period for changes in the temporary difference with a related adjustment to income tax expense (benefit).



Example 4.2.30

ITC – Deferral method

This fact pattern is the same as [Example 4.2.10](#).

ABC Corp operates in Country X, which provides ITCs for the development of certain renewable energy facilities. The ITC credit is 50% of the cost of qualified energy property placed in service. There is no limitation on how much of a given year's income taxes payable may be offset by the credit and unused credits can be carried over indefinitely, but not refunded. The tax rate in Country X is 21%.

On January 1, Year 1, ABC purchases qualified solar energy generation equipment for \$100,000 and immediately places it in service. The equipment will be depreciated for financial statement and income tax purposes on a straight-line basis over five years.

ABC receives \$100,000 tax basis in the equipment and an ITC of \$50,000 as a result of the purchase (50% × \$100,000 purchase price). ABC has no remaining obligation to earn the credit.

ABC elects the deferral method (**policy choice 1**).

The following table shows the journal entries in Year 1 depending on the policy choices made and compares the effects of those policy choices on the balance sheet and income statement. The steps, policy choices and outcomes of various combinations of policy choices (A1a through B2) are summarized in the table in [section 4.3.30](#).

Outcome (\$)	A1a	A1b	A2a	A2b	B1	B2
Entries on Jan 1, Year 1						
<i>Qualifying asset acquired:</i>						
Dr PPE	100,000	100,000	100,000	100,000	100,000	100,000
Cr Cash	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
<i>Step 1, policy choice 2:</i>						
Dr Income taxes payable	50,000	50,000	50,000	50,000	50,000	50,000
Cr PPE (contra-asset)	(50,000)	(50,000)	(50,000)	(50,000)		
Cr Deferred income					(50,000)	(50,000)

4. Nonrefundable, nontransferable tax credits

Outcome (\$)	A1a	A1b	A2a	A2b	B1	B2
<i>Step 2, policy choice 3:</i>						
Dr Deferred tax asset ¹	13,291	13,291	10,500	10,500	13,291	10,500
Cr PPE (contra-asset)	(13,291)	(13,291)			(13,291)	
Cr Deferred tax benefit			(10,500)	(10,500)		(10,500)
Entries during Year 1						
<i>Step 3, policy choice 4:</i>						
Dr Depr. expense ²	7,342	17,342	10,000	20,000	17,342	20,000
Cr PPE (accum. depr.)	(7,342)	(17,342)	(10,000)	(20,000)	(17,342)	(20,000)
Dr PPE (contra-asset)		10,000		10,000		
Dr Deferred income					10,000	10,000
Cr Current tax benefit		(10,000)		(10,000)	(10,000)	(10,000)
<i>Tax benefit of depr.:</i>						
Dr Income taxes payable	4,200	4,200	4,200	4,200	4,200	4,200
Cr Current tax benefit	(4,200)	(4,200)	(4,200)	(4,200)	(4,200)	(4,200)
<i>Step 4, change in deferred taxes:</i>						
Dr Deferred tax expense ³	2,658	2,658	2,100	2,100	2,658	2,100
Cr Deferred tax asset	(2,658)	(2,658)	(2,100)	(2,100)	(2,658)	(2,100)
Effect on Year 1 financial statements						
Assets						
PPE	29,367	29,367	40,000	40,000	69,367	80,000
Deferred tax asset	10,633	10,633	8,400	8,400	10,633	8,400
Cash	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
Net decrease	(60,000)	(60,000)	(51,600)	(51,600)	(20,000)	(11,600)

4. Nonrefundable, nontransferable tax credits

Outcome (\$)	A1a	A1b	A2a	A2b	B1	B2
Liabilities						
Deferred income					(40,000)	(40,000)
Income taxes payable	54,200	54,200	54,200	54,200	54,200	54,200
Net decrease	54,200	54,200	54,200	54,200	14,200	14,200
Profit after tax						
Depr. expense	7,342	17,342	10,000	20,000	17,342	20,000
Income tax benefit (net)	(1,542)	(11,542)	(12,600)	(22,600)	(11,542)	(22,600)
Net (increase) decrease	5,800	5,800	(2,600)	(2,600)	5,800	(2,600)
Year 1 effective tax rate	21%	67%	126%	113%	67%	113%
Years 2-5 effective tax rate ⁴	21%	67%	21%	61%	67%	61%
Notes:						
<p>1. For the policy choices in which the asset's carrying amount is reduced by the amount of the deferred tax effect that arises from deferring the ITC benefit (cases A1a, A1b and B1), the deferred tax effect is calculated using the simultaneous equation. This calculation is explained more fully in KPMG Handbook, Accounting for income taxes (from paragraph 10.001).</p> $(\text{tax rate} \div (1 - \text{tax rate})) \times (\text{tax basis} - \text{net carrying amount on balance sheet})$ $(21\% \div (1 - 21\%)) \times (\$100,000 - \$50,000) = \$13,291$						
<p>2. The financial statement carrying amount of the asset is depreciated by 20% in each case (Year 1 of 5-year useful life), but that carrying amount differs depending on the policy choices in Steps 1 and 2 (see section 4.2.30). In cases A1b and A2b, depreciation expense is computed based on the PPE carrying amount excluding the contra-asset account. This is because the benefit of the contra-asset account (i.e. the ITC benefit deferred in Step 1) is presented in income tax expense (benefit) in Step 3, policy choice 4.</p>						
<p>3. The change in deferred taxes is the end-of-year deferred tax asset minus the beginning-of-year deferred tax asset. The temporary difference used to measure the deferred tax asset at each date is the difference between the tax basis of the asset and its financial statement carrying amount (net of deferred income or the contra-asset, if any). The tax basis of the asset is depreciated by 20% in each case (Year 1 of 5-year useful life).</p>						
<p>4. The income tax benefit (expense) used to compute the effective tax rate in Years 2 to 5 is the total for the year minus the effect recognized on January 1.</p>						

4. Nonrefundable, nontransferable tax credits

4.2.40 What does it all mean?

What happens to an entity's financial statements with different permutations of the policy elections? The following table describes the outcomes.

Ref	Policy choice 1: Method	Policy choice 2: Present deferred ITC	Policy choice 3: Benefit of initial deferred tax	Policy choice 4: Present ITC benefit	Outcome
FT	Flow-through	N/A	N/A	N/A	Full tax benefit when the credit arises and an ongoing regular effective tax rate on pretax depreciation expense. (Example 4.2.20)
A1a	Deferral	Contra-asset	Simultaneous equation	Depreciation expense	No tax benefit when the credit arises and an ongoing regular effective tax rate on pretax depreciation expense; in addition, pretax depreciation expense is lower than any of the other cases. (Example 4.2.30 , case A1a)
A1b	Deferral	Contra-asset	Simultaneous equation	Income tax expense (benefit)	No tax benefit when the credit arises and a recurring additional income tax benefit over the asset's productive life; in addition, pretax depreciation expense is lower than cases FT, A2b, and B2. (Example 4.2.30 , cases A1b, B1)
B1	Deferral	Deferred income	Simultaneous equation	Income tax expense (benefit)	
A2a	Deferral	Contra-asset	Immediate	Depreciation expense	Some tax benefit when the credit arises and an ongoing regular effective tax rate on pretax depreciation expense; in addition, pretax depreciation expense is lower than cases FT, A1b, A2b, B1 and B2. (Example 4.2.30 , case A2a)
A2b	Deferral	Contra-asset	Immediate	Income tax expense (benefit)	Some tax benefit when the credit arises and a recurring additional income tax benefit over the asset's productive life. (Example 4.2.30 , cases A2b, B2)
B2	Deferral	Deferred income	Immediate	Income tax expense (benefit)	

4.3 Other application issues

4.3.10 IRA and CHIPS Act

Certain tax credits available under the IRA provide for increased and bonus credits if an entity satisfies prevailing wage, apprenticeship and domestic content requirements. The prevailing wage requirement extends from the beginning of construction through a specified compliance period (beyond the completion of construction). [Section 2.3.10](#) further describes the requirements of the increased and bonus credits.

The following table describes the accounting for the benefits of the nonrefundable, nontransferable increased and bonus credits based on the nature of the credit and the entity's policy choice.

PTC	Recognized in the year they arise – i.e. the year in which they become available to offset a company's income tax liability.
ITC – flow-through	Recognized in the year they arise.
ITC – deferral	Initially deferred on the balance sheet in the year they arise, and then are recognized in pretax income or income tax expense (benefit) over the productive life of the asset.

An entity applies the guidance for uncertainty in income taxes when accounting for these increased and bonus credits. [Section 4.2](#) discusses considerations around management's expectations and applying the uncertainty guidance when accounting for tax credits with ongoing requirements.

4.3.20 Interim period tax calculations

The annual income tax expense used to derive the entity's estimated annual effective tax rate generally includes all events expected to occur in the fiscal year affecting income tax expense related to ordinary income for which reliable estimates can be made. The benefits of ITCs generally are included when calculating the estimated annual effective rate. However, an entity may elect to exclude the net benefit from ITCs if it is using the deferral method for recognizing the benefit in income tax expense. [\[740-270-30-14\]](#)

Interim period tax calculations are explained further in KPMG Handbook, [Accounting for income taxes](#) (from paragraph 10.065).

4.3.30 Sponsors of tax credit structures

Owners of projects that generate tax credits may seek to monetize the tax credits by identifying another party (a 'tax equity investor') to invest in the project primarily to take advantage of the tax benefits. The owner (now sponsor) often establishes a controlled limited liability entity (or similar structure) and issues noncontrolling equity interests to the tax equity investor(s). The accounting by the tax equity investor is discussed in [section 5.2](#).

US GAAP provides no specific guidance on the method to allocate the investee's earnings among the investors. Sponsors often use the hypothetical liquidation at book value (HLBV) method as the basis for attributing the investee's comprehensive income between its controlling interest and the tax equity investor's noncontrolling interest (NCI). Under the HLBV method, an equity method investor determines its share of an investee's comprehensive income by comparing its claim on the investee's book value at the beginning and end of the period, assuming the investee were to liquidate all assets at their US GAAP amounts and distribute the resulting cash to creditors and investors under their respective priorities.

Although there is diversity in practice, we believe there are two primary methods used to adjust NCI on the allocation of the credits in the scope of Topic 740 to the NCI holder when HLBV is applied.

- Method 1: Adjust NCI immediately on allocation of the credits.
- Method 2: Adjust NCI over the recapture period of the ITCs.

The selection of the appropriate method may require judgment depending on the facts and circumstances. We do not believe it is appropriate for the sponsor to adjust NCI over the asset's depreciable life for tax purposes, the period the NCI holder(s) expects to hold its investment or the period the tax equity investor is expected to achieve the specified internal rate of return. See section 7.5 in KPMG Handbook, [Consolidation](#), for additional discussion.

5. Investors in tax credit structures

Detailed contents

5.1 How the standard works

5.2 Accounting for equity method investments in tax credit structures

5.3 Accounting for ITC benefits

5.3.10 Flow-through method

5.3.20 Deferral method

5.3.30 What does it all mean?

Examples

5.3.10 Flow-through method – tax credit investor

5.3.20 Deferral method – tax credit investor

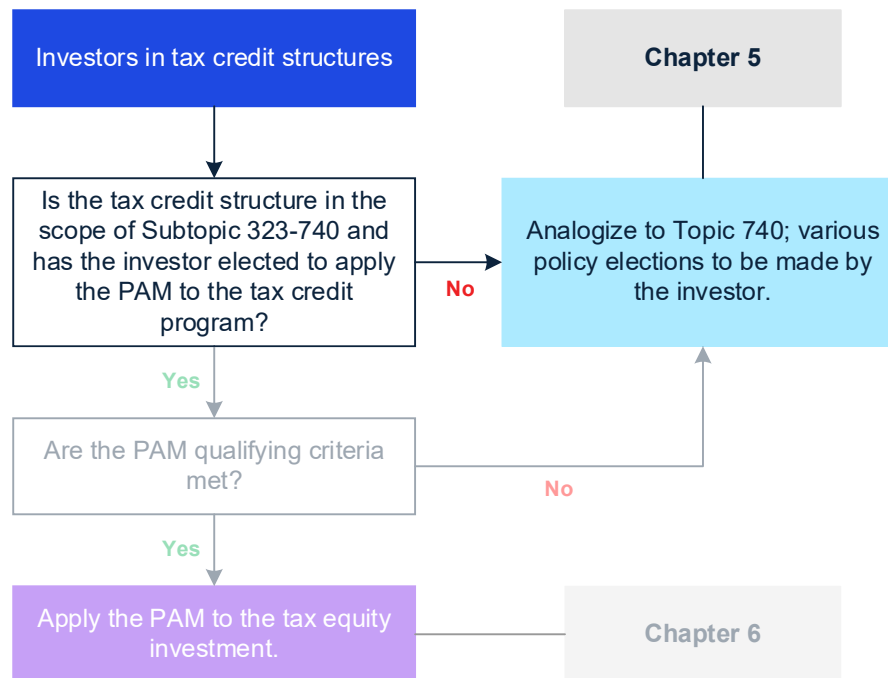
5.3.30 Deferral method – tax equity investment accounted under ASC Topic 825

5.3.40 Deferral method – leased property

5.4 Accounting for other tax credits

5.1 How the standard works

This chapter addresses the accounting for tax credits allocated to tax equity investors (when the PAM is not elected and applied).



Developers of projects that generate tax credits may seek to monetize the tax credits by partnering with tax equity investors. These arrangements generally result in tax equity investors making investments in a pass-through entity that will receive income tax credits (ITCs and other credits) and other income tax benefits that pass through to the tax equity investors.

Depending on the facts and circumstances, investments in tax credit structures that are not consolidated might be accounted for using the equity method, Topic 321 (investments in equity securities) or the PAM. This chapter focuses on investments in tax credit structures using the equity method under Topic 323 and the fair value option under Topic 825. [Chapter 6](#) further discusses the accounting when the PAM is elected by tax equity investors under Subtopic 323-740.

5. Investors in tax credit structures

Although Topic 740 does not address the accounting for tax credits allocated to equity investors, we believe it is generally appropriate to analogize to its guidance on how to recognize income tax credits generated directly by the investor.

There is diversity in the accounting by an investor that recognizes the benefits of income tax credits through its noncontrolling interests in pass-through entities.

5.2 Accounting for equity method investments in tax credit structures

An entity that invests in a pass-through tax credit structure (a tax credit investor) typically recognizes and measures its investment in the investee based on the guidance in Topic 323 (equity method). That guidance generally requires the investor to initially measure its investment at cost and recognize its share of the investee's profit or loss each reporting period.

We believe that most tax equity investments for which the PAM has not been applied would be accounted for as equity method investments based on the following guidance.

- Paragraph 970-323-25-6 requires an investor to account for its investments in real estate ventures under the equity method unless its interest is so minor that it has virtually no influence.
- Paragraph 323-30-S99-1 states that the SEC staff considers investments of more than 3-5% to be more than minor when applying the paragraph 970-323-25-6 guidance.

Accounting for the equity method investment upon the allocation of tax credits to equity method investors

Although Topic 740 does not address the accounting for tax credits allocated to equity method investors, we believe it is appropriate to analogize to its guidance on how to recognize the income tax credit benefits arising from direct investments in qualifying assets – i.e. a tax credit investor can apply the flow-through method or the deferral method (**policy choice 1**, see [section 4.2](#) for further discussion). Tax equity investors (or other tax-paying entities that ultimately benefit from tax credits generated by pass-through investments) should apply the same policy for accounting for the benefits of the tax credits that they apply to their owned assets.

In addition, there are pretax considerations when applying Topic 323 to these investments. When the investee that generates the tax credits allocates them, clauses in the operating agreement will generally cause the investee to reallocate its equity capital among its investors to reflect the return provided to the tax equity investor. After the allocation of the tax credits and the reallocation of capital, the tax equity investor's claim to the investee's net assets is often less than before.

A tax credit investor typically uses the HLBV method to measure its share of the investee's profit or loss. Under HLBV, the investor computes at the beginning and end of the reporting period its share of the investee's net assets assuming the investee:

- liquidated its net assets at their book values; and
- distributed the proceeds to the investors based on the distribution waterfall in the investment agreement.

The change in the investor's share of the investee's net assets from the beginning to the end of the reporting period (after adjusting for contributions and distributions) represents the investor's share of the investee's earnings from its investment. The change is recognized in equity in earnings (losses) each reporting period, along with any investor-level adjustments – e.g. amortization of purchase price premiums/discounts associated with the investee's underlying assets and liabilities and elimination of certain intra-entity profits and losses.

Determining the investor's share of the investee's net assets may be complex. An investor analyzes the investment agreement to determine its claim based on how cash would be distributed from operations and on liquidation under the contractual provisions to the extent they are specified. In some cases, the investment agreement is silent (or unclear) about cash distributions and the investor needs to interpret its conditions to determine how cash would be distributed if the investee was hypothetically liquidated at the reporting date. However, in any case, an investor's determination must be consistent with the contractual provisions of the investment agreement.

We believe an investor that uses the HLBV method may account for the decrease in its capital account resulting from the allocation of tax credits under what we call a 'point in time approach' or a 'basis difference approach' (**policy choice 5**).

- **Point-in-time approach**

Under the point-in-time approach, when the investee reallocates its equity capital, the investor recognizes a charge to equity in earnings (losses) equal to the decrease in its claim to the investee's net assets. An investor using this approach accounts for the capital reallocation resulting from allocation of tax credits in the same way that it accounts for other changes to its share of the investee's net assets when applying HLBV.

An investor generally uses this approach when it applies the flow-through method of accounting for the receipt of ITCs. This is because the immediate income tax benefit of the ITC will largely offset the immediate charge to equity in earnings (losses).

- **Basis difference approach**

Under the basis difference approach, when the investee reallocates its equity capital, the investor identifies a basis difference related to the investee's qualifying asset – i.e. the asset that gave rise to the tax credit. That basis difference equals the decrease in the investor's share of the investee's net assets resulting from the allocation of ITCs and is amortized to equity in earnings (losses) in the same periods that the investee depreciates the qualifying asset.

An investor generally uses this approach when it applies the deferral method of accounting for ITCs. This is because the income tax benefit of the ITCs recognized over time will largely offset the charge to equity in earnings (losses) resulting from the basis difference amortization.

These methods are described and illustrated in the sections and examples that follow to compare the accounting policy choices that are available. See section 4.3 of KPMG Handbook, [Equity method of accounting](#), for additional background.

Regardless of the approach used to account for the capital reallocation, an investor evaluates its investment for impairment, as necessary. For example, we believe an investor evaluates its tax equity investments accounted for under the equity method for impairment when there is a change in tax law that may indicate that a decrease in value has occurred. An equity method investment is impaired if its fair value under Topic 820 (fair value) is less than its financial statement carrying amount.

If an investor concludes that its investment is impaired at the reporting date, it determines whether the impairment is temporary or other-than-temporary. If an investor concludes that an impairment is other-than-temporary, it reduces the carrying amount of the investment to its fair value by recognizing a charge to its income statement. The investor generally recognizes the impairment charge in the same line that it presents its equity in earnings (losses) of the investee; however, it may be appropriate to present it elsewhere – e.g. when the other-than-temporary impairment is due solely to a change in tax law (see [section 6.4.80](#)).

Delayed equity contributions

When an investor does not apply the PAM, delayed equity contributions are accounted for using the model otherwise applied to account for equity investments and no liability is recognized. For example, if an investor applies the equity method to account for an equity investment, then the guidance in Subtopic 323-30 is used to account for any delayed equity contributions. Applying this guidance generally would not result in the investor recognizing delayed equity contributions on a gross basis, which is different from how they are recognized under the PAM.

5.3 Accounting for ITC benefits

5.3.10 Flow-through method

There are three steps to applying the combination of the (1) flow-through method (to account for the ITC benefit), and (2) the point-in-time approach (to account for the decrease in the tax credit investor's claim to the investee's net assets).

These steps are described below, and the impact on the financial statements is illustrated in [Example 5.3.10](#). Although these steps are similar to, and in some cases the same as, the steps in applying the deferral method, they are not presented in a similar table to avoid implying that the same array of policy choices applies.

- **Step 1: Immediately recognize the income tax benefit**

An investor applying the flow-through method immediately recognizes the ITC benefit in income tax expense (benefit).

- **Step 2: Recognize the equity method charge**

An investor applying the flow-through method typically applies the point-in-time approach to account for the decrease in its capital account when the ITC is allocated. An investor applying the point-in-time approach recognizes the reduction of its investment immediately in equity in earnings (losses).

- **Step 3: Recognize deferred taxes on the temporary difference that arises from recognizing the reduction in the equity method investment that results from the allocation of the ITCs**

When the investor adjusts the financial statement carrying amount of the investment and recognizes the related equity method loss resulting from the allocation in Step 2, it may also have a reduction in the tax basis of the investment from the tax credit recognized in Step 1. If the reduction in the tax basis is less than the adjustment to the financial statement carrying amount, a deductible temporary difference will arise.

We believe an investor may recognize the initial deferred tax effect that arises from recognizing a reduction in the equity method investment that results from the allocation of the ITCs immediately in income tax expense (benefit) or further adjusting the financial statement carrying amount of the investment.

If the investor elects to adjust the financial statement carrying amount of the investment, the temporary difference will also change, and the calculation becomes circular. The investor solves for this circularity by using the 'simultaneous equation.' See additional discussion on the simultaneous equation in [section 4.2.30](#).



Example 5.3.10

Flow-through method – tax credit investor

ABC Corp invests in Energy LLC, an alternative energy entity. ABC invests \$65,000 for an equity interest in Energy. Energy is a pass-through entity and ABC accounts for its investment under the equity method. Both entities operate in Country X.

Energy constructs offshore wind facilities that are eligible for an ITC equal to 50% of the cost of qualified energy property placed in service. There is no limitation on how much of a given year's income taxes payable may be offset by the credit

5. Investors in tax credit structures

and unused credits can be carried over indefinitely, but not refunded. Under the investment agreement, all the ITCs are allocated to ABC. The tax rate in Country X is 21%.

On January 1, Year 1, Energy purchases eligible offshore wind facility equipment for \$100,000 and immediately places it in service. The equipment will be depreciated for financial statement and income tax purposes on a straight-line basis over five years. Under the investment agreement, ABC is allocated 30% of Energy's operating income or loss, including depreciation.

Energy receives \$100,000 tax basis in the equipment and generates an ITC of \$50,000 as a result of the purchase (50% × \$100,000 purchase price). Energy has no remaining obligation to earn the credit and allocates it entirely to ABC. ABC:

- does not have a reduction of its tax basis in its investment in Energy as a result of the allocation of the credits;
- needs no valuation allowance on its deferred tax assets; and
- expects to have taxable income and an overall income tax liability for all years.

ABC applies the flow-through method (policy choice 1) to account for the ITC benefit and the point-in-time approach (policy choice 5) to account for the decrease in its capital account. It measures its point-in-time charge as \$50,000 and has an accounting policy to recognize the initial deferred tax effect of the reduction in the equity method investment by further adjusting the financial statement carrying amount of the investment. Further, it presents equity method earnings (loss) in pretax income.

The following tables show the journal entries in Year 1 and their effects on the balance sheet and income statement.

Entries on Jan 1, Year 1 (\$)		Entries during Year 1 (\$)	
<i>Investment acquired:</i>		<i>Recognize pass-through depr.:</i>	
Dr Investment in Energy	65,000	Dr Equity in losses ³	6,000
Cr Cash	(65,000)	Cr Investment in Energy	(6,000)
<i>Step 1, ITC tax benefit recognized:</i>		<i>Tax benefit of pass-through depr.:</i>	
Dr Income taxes payable	50,000	Dr Income taxes payable	1,260
Cr Current tax benefit	(50,000)	Cr Current tax benefit	(1,260)
<i>Step 2, basis difference recognized:</i>			
Dr Equity in losses	50,000		
Cr Investment in Energy	(50,000)		

Entries on Jan 1, Year 1 (\$)	
<i>Step 3, deferred taxes on investment recognized:</i>	
Dr Deferred tax asset ¹	13,291
Cr Investment in Energy ²	(13,291)

Effect on Year 1 financial statements (\$)			
Assets		Profit after tax	
Investment in Energy	(4,291)	Equity in losses	56,000
Deferred tax asset ⁴	13,291	Income tax benefit (net)	(51,260)
Cash	(65,000)	Net decrease	4,740
Net decrease	(56,000)	Year 1 effective tax rate ⁵	92%
Liabilities		Years 2-5 effective tax rate ⁶	21%
Income taxes payable	51,260		
Decrease	(51,260)		
Decrease in net assets	(4,740)		

Notes:

- The deferred tax effect is calculated using the simultaneous equation. This calculation is explained more fully in KPMG Handbook, [Accounting for income taxes](#) (from paragraph 6.015).

$$(\text{tax rate} \div (1 - \text{tax rate})) \times (\text{tax basis} - \text{net carrying amount on balance sheet})$$

$$(21\% \div (1 - 21\%)) \times (\$65,000 - \$15,000) = \$13,291$$
- Alternatively, the investor may recognize the initial deferred tax effect that arises from recognizing the reduction in the equity method investment that results from the allocation of the ITCs at the date of the investment by recognizing it immediately in income tax expense (benefit) (see additional discussion in Step 3 of [section 5.3.10](#)).
- For illustrative purposes, equity in losses equals pass-through depreciation expense, or 30% of Energy's annual \$20,000 (\$100,000 ÷ 5 years) depreciation expense. The actual amount of equity in earnings (losses) for the period would be determined using the HLBV method as discussed in [section 5.2](#).
- There is no additional change in deferred taxes related to the Investment in Energy. This is because after Step 3 no incremental difference arises between the financial statement carrying amount and the tax basis.

5. The effective tax rate on equity in losses in Year 1 is explained by an expected tax benefit of \$11,760 ($\$56,000$ pretax loss \times 21%), less a \$10,500 effect of the pretax point-in-time charge with no income tax benefit in the income statement ($\$50,000 \times 21\%$), plus the income tax benefit of the tax credit of \$50,000.
6. The effective tax rate on equity in losses in Years 2 to 5 is income tax benefit for the year minus the effect recognized on January 1 ($\$51,260 - \$50,000 = \$1,260$) divided by ABC's annual pass-through depreciation expense ($30\% \times (\$100,000 \text{ equipment cost} \div 5 \text{ years}) = \$6,000$).

5.3.20 Deferral method

There are four steps to applying the combination of the (1) deferral method (to account for the ITC benefit), and (2) basis difference approach (to account for the decrease in the tax credit investor's claim to the investee's net assets).

These steps are illustrated in the following table and described below. The impact on the financial statements of each permutation is then described in [section 5.3.30](#) and illustrated in [Example 5.3.20](#).

Principle		ITC benefits and capital reallocation are deferred and recognized over the productive life of the qualifying property			
Step 1	Initially defer the ITC benefit				
	No policy choice: Reduce carrying amount of equity method investment				
Step 2	Recognize deferred taxes on the temporary difference that arises from initially deferring the ITC benefit				
Policy choice 3	Reduce carrying amount of asset (contra-asset)		Immediately in income tax expense (benefit)		
	A		B		
Step 3	Recognize the deferred ITC benefit over the productive life of the qualifying property				
Policy choice 4	Equity in earnings (losses)	Income tax expense (benefit)	Equity in earnings (losses)	Income tax expense (benefit)	
	A1¹	A2	B1	B2	
Step 4	Recognize amortization of the equity method basis difference				
Step 5	Adjust deferred taxes based on the temporary difference that exists at the reporting date				
Note:					
1. The final outcomes of applying the different policy choices correspond to the outcomes illustrated in Example 5.3.20 .					

Step 1: Initially defer the ITC benefit

An investor applying the deferral method defers the ITC benefit by reducing the carrying amount of its equity method investment on initial recognition (i.e. Day 1). In some cases, this entry results in a credit balance in the investment account. We believe liability presentation in this case is appropriate even if the investor is not committed to fund investee losses (if any). This is because the credit amount is representative of the investor deferring its ITC benefit versus recognizing more equity in losses than the financial statement carrying amount of its investment.

An investor generally does not initially defer the ITC benefit by recognizing a deferred income liability in addition to its investment account because Topic 323 requires an investor to show its equity method investment as a single amount. [\[323-10-45-1\]](#)

Fair value option under Topic 825

If an investor elects the fair value option under Topic 825 (financial instruments) for an investment in the scope of Topic 323, we believe it should present the deferred ITC benefit as a deferred income liability – not as a reduction in the carrying amount of its investment.

Step 2: Recognize deferred taxes on the temporary difference that arises from initially deferring the ITC benefit

Policy choice 3: We believe an investor may recognize the deferred tax effect that arises from deferring the ITC benefit immediately in income tax expense (benefit) or by further adjusting the financial statement carrying amount of the investment.

If the investor elects to adjust the financial statement carrying amount of the investment, the temporary difference will also change, and the calculation becomes circular. The investor solves for this circularity by using the ‘simultaneous equation.’ See additional discussion on the simultaneous equation in [section 4.2.30](#).

Fair value option under Topic 825

If an investor applies the fair value option under Topic 825, we believe it should immediately recognize in income tax expense the deferred tax on the temporary difference that arises from initially deferring the ITC benefit.

Step 3: Recognize the deferred ITC benefit over the productive life of the underlying qualifying property

We believe an investor should recognize the periodic ITC benefit over the productive life of the underlying qualifying property giving rise to the tax credit.

We believe it is generally inappropriate for the investor to recognize the ITC benefit over the:

- period the investee must hold the asset to avoid recapture of the tax credit;

- depreciable life of the asset for income tax purposes; or
- period the investor expects to hold its equity method investment.

Policy choice 4: We believe an investor may present the benefit in income tax expense (benefit) or in equity in earnings (losses).

Fair value option under Topic 825

If an investor applies the fair value option under Topic 825, we believe it should present the periodic benefit as income tax expense. Further, we believe the investor's remeasurement to fair value of the investment is not affected by the deferred income liability amount. The periodic fair value adjustment is computed and recognized independently of the income tax benefit, which is being recognized in earnings over the productive life of the underlying asset giving rise to the ITC.

Step 4: Recognize periodic amortization of the equity method basis difference

An investor using the basis difference approach amortizes the basis difference (generally equal to the ITC received) over the productive life of the underlying qualifying property with a charge to equity in earnings (losses) and a credit to the investment. In Step 4, it is assumed that the investor will choose the basis difference approach (**policy choice 5**; see [section 5.2](#)) in accounting for the decrease in its capital account.

Step 5: Adjust deferred taxes based on the temporary difference that exists at the reporting date

An investor adjusts its deferred taxes each period for changes in the temporary difference with a related adjustment to income tax expense (benefit).



Example 5.3.20
Deferral method – tax credit investor

The fact pattern is the same as [Example 5.3.10](#).

ABC Corp invests \$65,000 in Energy LLC, an alternative energy entity, for an equity interest. Energy is a pass-through entity and ABC accounts for its investment under the equity method. Both entities operate in Country X.

Energy constructs offshore wind facilities that are eligible for an ITC equal to 50% of the cost of qualified energy property placed in service. There is no limitation on how much of a given year's income taxes payable may be offset by the credit

5. Investors in tax credit structures

and unused credits can be carried over indefinitely, but not refunded. Under the investment agreement, all the ITCs are allocated to ABC. The tax rate in Country X is 21%.

On January 1, Year 1, Energy purchases eligible offshore wind facility equipment for \$100,000 and immediately places it in service. The equipment will be depreciated for financial statement and income tax purposes on a straight-line basis over five years. Under the investment agreement, ABC is allocated 30% of Energy's operating income or loss, including depreciation.

Energy receives \$100,000 tax basis in the equipment and generates an ITC of \$50,000 as a result of the purchase (50% × \$100,000 purchase price). Energy has no remaining obligation to earn the credit and allocates it entirely to ABC. ABC does not have a reduction of its tax basis in its investment in Energy as a result of the allocation of the credits. ABC needs no valuation allowance on its deferred tax assets. ABC expects to have taxable income and an overall income tax liability for all years.

ABC elects the deferral method (**policy choice 1**) to account for the ITC benefit and the basis difference approach (**policy choice 5**) to account for the decrease in its capital account.

The following table shows the journal entries in Year 1 depending on the policy choices made and compares the effects of those policy choices on the balance sheet and income statement. The steps, policy choices and outcomes of various combinations of policy choices (A1 through B2) are summarized in the table in [section 5.3.20](#).

Outcome (\$)	A1	A2	B1	B2
Entries on Jan 1, Year 1				
<i>Investment acquired:</i>				
Dr Investment in Energy	65,000	65,000	65,000	65,000
Cr Cash	(65,000)	(65,000)	(65,000)	(65,000)
<i>Step 1, defer ITC benefit:</i>				
Dr Income taxes payable	50,000	50,000	50,000	50,000
Cr Investment in Energy	(50,000)	(50,000)	(50,000)	(50,000)
<i>Step 2, policy choice 3:</i>				
Dr Deferred tax asset ¹	13,291	13,291	10,500	10,500
Cr Investment in Energy	(13,291)	(13,291)		
Cr Deferred tax benefit			(10,500)	(10,500)

5. Investors in tax credit structures

Outcome (\$)	A1	A2	B1	B2
Entries during Year 1				
<i>Step 3, policy choice 4:</i>				
Dr Equity in losses ²	6,000	6,000	6,000	6,000
Cr Investment in Energy	(6,000)	(6,000)	(6,000)	(6,000)
<i>Tax benefit of depr.:</i>				
Dr Income taxes payable	1,260	1,260	1,260	1,260
Cr Current tax benefit	(1,260)	(1,260)	(1,260)	(1,260)
<i>Step 3, policy choice 4:</i>				
Dr Investment in Energy	10,000	10,000	10,000	10,000
Cr Equity in losses	(10,000)		(10,000)	
Cr Current tax benefit		(10,000)		(10,000)
<i>Step 4, amortize basis difference:</i>				
Dr Equity in losses	10,000	10,000	10,000	10,000
Cr Investment in Energy	(10,000)	(10,000)	(10,000)	(10,000)
<i>Step 5, change in deferred taxes³:</i>				
Dr Deferred tax expense	–	–	–	–
Cr Deferred tax asset	–	–	–	–
Effect on Year 1 financial statements				
Assets				
Investment in Energy	(4,291)	(4,291)	9,000	9,000
Deferred tax asset	13,291	13,291	10,500	10,500
Cash	(65,000)	(65,000)	(65,000)	(65,000)
Net decrease	(56,000)	(56,000)	(45,500)	(45,500)

5. Investors in tax credit structures

Outcome (\$)	A1	A2	B1	B2
Liabilities				
Income taxes payable	51,260	51,260	51,260	51,260
Net decrease	51,260	51,260	51,260	51,260
Profit after tax				
Equity in losses	6,000	16,000	6,000	16,000
Income tax benefit (net)	(1,260)	(11,260)	(11,760)	(21,760)
Net (increase) decrease	4,740	4,740	(5,760)	(5,760)
Year 1 effective tax rate on equity in losses	21%	70%	196%	136%
Years 2-5 effective tax rate ⁴ on equity in losses	21%	70%	21%	70%

Notes:

- For the policy choices in which the investment's carrying amount is reduced by the amount of the deferred tax effect that arises from deferring the ITC benefit (A1 and A2), the deferred tax effect is calculated using the simultaneous equation. This calculation is explained more fully in KPMG Handbook, [Accounting for income taxes](#) (from paragraph 6.015).

$$(\text{tax rate} \div (1 - \text{tax rate})) \times (\text{tax basis} - \text{net carrying amount on balance sheet})$$

$$(21\% \div (1 - 21\%)) \times (\$65,000 - \$15,000) = \$13,291$$
- For illustrative purposes, equity in losses equals pass-through depreciation expense, or 30% of Energy's annual \$20,000 (\$100,000 ÷ 5 years) depreciation expense. The actual amount of equity in earnings (losses) for the period would be determined using the HLBV method as discussed in [section 5.2](#).
- There is no additional change in deferred taxes related to the Investment in Energy because after Step 4, no incremental difference arises between the financial statement carrying amount and the tax basis.
- The effective tax rate on equity in losses in Years 2 to 5 is the income tax benefit for the year minus the effect recognized on January 1 divided by ABC's annual pass-through depreciation expense (30% × (\$100,000 equipment cost ÷ 5 years)).



Example 5.3.30

Deferral method – tax equity investment accounted under ASC Topic 825

ABC Corp operates in Country X and invests \$65,000 for an ownership interest in Energy LLC, an alternative energy entity. Energy is a pass-through entity and ABC accounts for its investment in Energy using the fair value option under Topic 825.

Energy constructs facilities that are eligible for a 50% ITC. There is no limitation on how much of a given year's income taxes payable may be offset by the credit and unused credits can be carried over indefinitely, but not refunded. Energy allocates all of its ITCs to ABC under its partnership agreement. The tax rate in Country X is 21%.

ABC directly owns eligible property outside of its investment in Energy and applies the deferral method (policy choice 1) when accounting for the related ITCs. ABC recognizes the income tax benefit related to the initial deferred tax asset as an immediate adjustment to income tax expense (policy choice 3).

On January 1, Year 1, Energy purchases and places in service \$100,000 of eligible assets. The productive life of the assets is five years for book and income tax purposes. Under the investment agreement, ABC is allocated 30% of Energy's operating income or loss, including depreciation.

Energy receives full tax basis in the assets and generates an ITC of \$50,000 as a result of the purchase (50% × \$100,000 purchase price). Energy has no remaining obligation to earn the credit and allocates it entirely to ABC. ABC does not have a reduction of its tax basis in its investment in Energy as a result of the allocation of the credits. ABC can use the full credit in the year it arises and needs no valuation allowance on its deferred tax assets.

During Year 1, the fair value of ABC's investment in Energy decreases by \$40,000. Also, ABC is allocated a \$6,000 tax loss.

The following tables show the journal entries in Year 1 and their effects on the balance sheet and income statement.

Entries on Jan 1, Year 1		Entries during Year 1	
<i>Investment acquired:</i>		<i>Tax benefit of pass-through loss:</i>	
Dr Investment in Energy	65,000	Dr Income taxes payable	1,260 ⁵
Cr Cash	(65,000)	Cr Current tax benefit	(1,260)

5. Investors in tax credit structures

Entries on Jan 1, Year 1	Entries during Year 1
<i>Step 1, initially defer ITC:</i>	<i>Step 3, recognize ITC benefit over productive life:</i>
Dr Income taxes payable 50,000 ¹	Dr Deferred income 10,000 ⁶
Cr Deferred income ² (50,000)	Cr Current tax benefit (10,000)
<i>Step 2, recognize deferred taxes on deferred income:</i>	<i>Step 5, adjust deferred taxes:</i>
Dr Deferred tax asset 10,500 ³	Dr Deferred tax asset 5,040 ⁷
Cr Deferred tax benefit ⁴ (10,500)	Cr Deferred tax benefit (5,040)
	<i>Recognize fair value adjustment:</i>
	Dr Equity in losses 40,000
	Cr Investment in Energy (40,000)
Notes:	
1. $\$100,000 \times 50\%$ ITC rate	
2. We believe an investor that applies the deferral method should present the deferral as a deferred income liability if it is applying the fair value option instead of the equity method of accounting as discussed in section 5.3.20 .	
3. $(\$50,000 \text{ deferred income} - \$0 \text{ tax basis}) \times 21\%$ tax rate	
4. We believe an investor that applies the fair value option should immediately recognize any deferred tax effect in income tax expense (benefit) (see additional discussion in Step 3 of section 5.3.20).	
5. $\$6,000 \text{ tax loss} \times 21\%$ tax rate	
6. $\$50,000 \text{ deferred ITC benefit} \div 5 \text{ years}$	
7. Deferred tax benefit is the change in the net deferred tax assets and liabilities (the \$15,540 deferred tax asset at December 31, Year 1 minus the \$10,500 deferred tax asset at January 1, Year 1). The ending net deferred tax asset of \$15,540 is calculated as $21\% \times [(\$59,000 \text{ tax basis of investment} (\$65,000 \text{ initial basis} - \$6,000 \text{ tax loss for Year 1}) - \$25,000 \text{ book basis of investment} (\$65,000 \text{ initial basis} - \$40,000 \text{ fair value adjustment}) + \$40,000 (\$40,000 \text{ book basis of deferred income} - \text{zero tax basis at December 31, Year 1})]$	

Effect on Year 1 financial statements (\$)			
Assets		Profit after tax	
Investment in Energy	25,000	Equity in losses	40,000
Deferred tax asset	15,540	Income tax benefit (net)	(26,800)
Cash	(65,000)	Net decrease	13,200
Net decrease	(24,460)	Year 1 effective tax rate	67%
Liabilities			
Income taxes payable	51,260		
Deferred income	(40,000)		
Net decrease	11,260		
Decrease in net assets	(13,200)		



Example 5.3.40 Deferral method – leased property

ABC Corp invests in various historic building rehabilitation projects through pass-through entities. It invests \$65,000 for an interest in DEF Fund, LP, which runs a rehabilitation operations business in neglected historic downtowns across the US.

XYZ LLC, an unrelated party, recently rehabilitated a historic building for \$100,000 and places it in service on December 31, Year 1. XYZ is entitled to an ITC equal to 50% of the investment. The credit's mechanics are such that the owner's tax basis in the property is reduced for the credit received.

DEF agrees to lease the historic building from XYZ for \$5,000 a year. As part of the lease agreement, XYZ makes a lease pass-through election to treat DEF as having acquired the building for purposes of the ITC. The useful life of the building is 39 years under the relevant tax law.

The ITC that DEF is entitled to for the property is allocated entirely to ABC under its partnership agreement. Because DEF has no tax basis in the property to reduce by the amount of the ITC, income tax regulations under section 50(d)

require ABC to include an amount in its taxable income equal to its allocated ITC ratably over the 39-year tax depreciable life for the property. There is no limitation on how much of a given year's income taxes payable may be offset by the credit and unused credits can be carried over indefinitely, but not refunded. The tax rate is 21%.

ABC accounts for its investment in DEF using the equity method and elects to use the deferral method of accounting for all of its ITCs received (policy choice 1). ABC presents the tax benefit of ITCs as a reduction in the financial statement carrying amount of the investment.

ABC will recognize income under section 50(d) over the tax depreciable life of the property. As a result, it recognizes a deferred tax liability for the tax effect of the entire amount of the income inclusion. Further, it recognizes a deferred tax asset for the reduction in the financial statement carrying amount of the investment in DEF resulting from deferring the ITC benefit. Because the amount of the deferred tax asset and liability are equal, there is no net income tax expense (benefit) when XYZ places the asset in service.

The following table shows ABC's journal entries in Year 1.

Entries on Dec 31, Year 1	
<i>Investment acquired:</i>	
Dr Investment in DEF	65,000
Cr Cash	(65,000)
<i>Step 1, initially defer ITC:</i>	
Dr Income taxes payable	50,000 ¹
Cr Investment in DEF	(50,000)
<i>Step 2, recognize deferred taxes on investment in DEF:</i>	
Dr Deferred tax asset	10,500 ²
Cr Deferred tax benefit	(10,500)
<i>Recognize deferred taxes on income inclusion</i>	
Dr Deferred tax expense	10,500 ³
Cr Deferred tax liability	(10,500)
Notes:	
1. \$100,000 qualifying investment x 50% ITC rate x 100% allocation percentage from DEF to ABC.	

2. $[\$65,000 \text{ tax basis} - (\$65,000 \text{ initial investment in DEF} - \$50,000 \text{ ITC})] \times 21\% \text{ tax rate}$
3. $\$50,000 \text{ ITC} \times 100\% \text{ (ABC's allocation from DEF)} \times 21\% \text{ income tax rate}$. Note that ABC will reverse the deferred tax liability as it recognizes the taxable income over the tax depreciable life of the building.

5.3.30 What does it all mean?

What happens to an investor's financial statements with different permutations of the policy elections? The following table describes the outcomes.

Ref	Policy choice 1: Method	Policy choice 3: Benefit of initial deferred tax	Policy choice 4: Present ITC benefit	Policy choice 5: Pretax effect of capital reallocation	Outcome
FT	Flow-through	N/A	N/A	Point-in-time	Full tax benefit and pretax loss when the credit arises and an ongoing regular effective tax rate on pretax equity in losses from pass-through depreciation expense (Example 5.3.10)
A1	Deferral	Simultaneous equation	Equity in earnings (losses)	Basis difference	No tax benefit when the credit arises and an ongoing regular effective tax rate on pretax equity in losses; in addition, pretax equity in losses is lower than scenarios FT, A2, and B2 (Example 5.3.20 , case A1)
A2	Deferral	Simultaneous equation	Income tax expense (benefit)	Basis difference	No tax benefit when the credit arises and a recurring additional income tax benefit (Example 5.3.20 , case A2)
B1	Deferral	Immediate	Equity in earnings (losses)	Basis difference	Some income tax benefit when the credit arises and an ongoing regular effective tax rate on pretax equity in losses; in addition, pretax equity in losses is lower than scenarios FT, A2, and B2 (Example 5.3.20 , case B1)

Ref	Policy choice 1: Method	Policy choice 3: Benefit of initial deferred tax	Policy choice 4: Present ITC benefit	Policy choice 5: Pretax effect of capital reallocation	Outcome
B2	Deferral	Immediate	Income tax expense (benefit)	Basis difference	Some income tax benefit when the credit arises and an abnormally high effective tax rate on pretax equity in losses (Example 5.3.20 , case B2)

5.4 Accounting for other tax credits

Other tax credits include, but are not limited to, production tax credits, certain research and experimentation credits, work opportunity credits and foreign tax credits. There are three steps to applying the combination of the (1) flow-through method (to account for the tax credit benefit), and (2) the point-in-time approach (to account for the decrease in the tax credit investor's claim to the investee's net assets).

- **Step 1: Immediately recognize the income tax benefit**

An investor immediately recognizes the tax credit benefit in income tax expense (benefit).

- **Step 2: Recognize the equity method charge**

We believe an investor in an equity method investment generating other tax credits should apply the point-in-time approach to account for any decrease in its capital account when the tax credit is allocated. An investor applying the point-in-time approach recognizes the reduction of its investment immediately in equity in earnings (losses).

- **Step 3: Recognize deferred taxes on the temporary difference that arises from recognizing the reduction in the equity method investment that results from the allocation of the tax credits**

When the investor adjusts the financial statement carrying amount of the investment and recognizes the related equity method loss resulting from the allocation in Step 2, a deductible temporary difference may arise.

We believe an investor recognizes the initial deferred tax effect that arises from recognizing a reduction in the equity method investment that results from the allocation of the tax credits immediately in income tax expense (benefit).

6. Proportional amortization method

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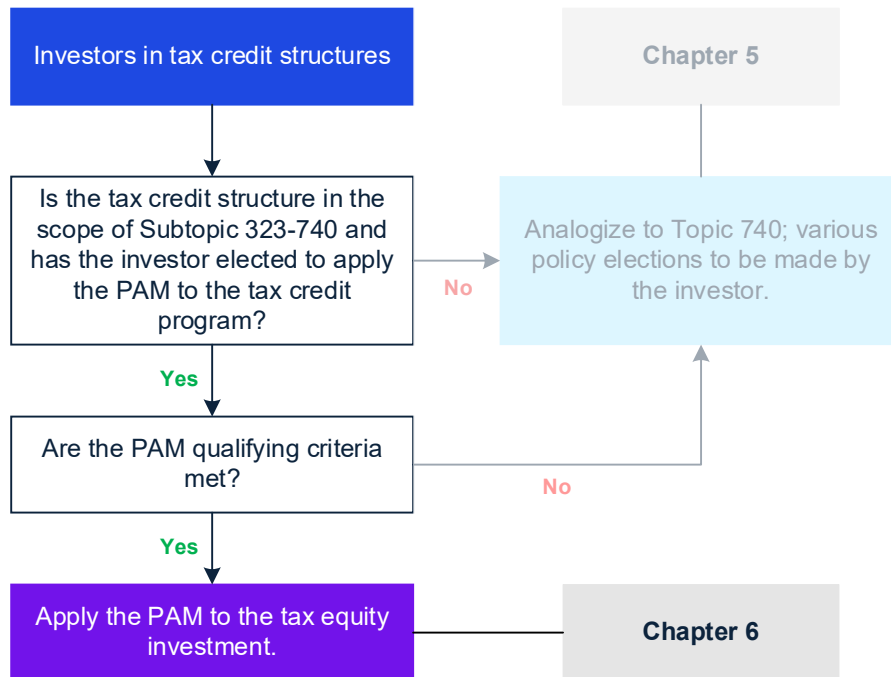
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6.6.20 Prospective application of removal of the cost method guidance

6.1 How the standard works

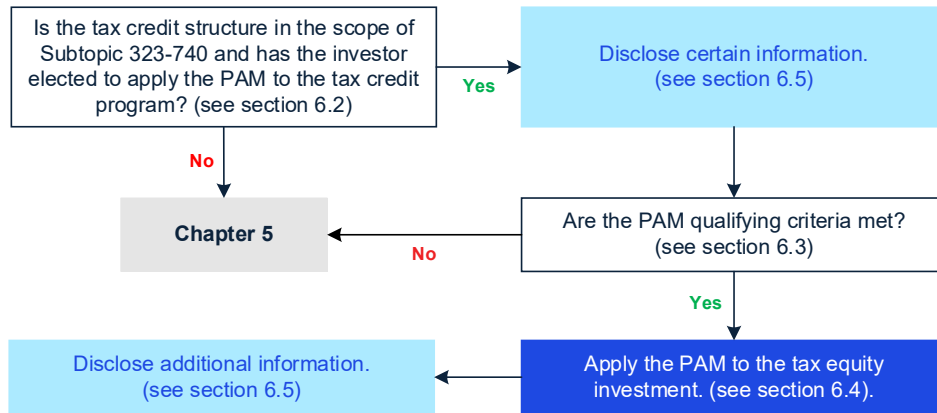
When applying the PAM, an investor in a tax credit structure amortizes its investment through income tax expense or benefit. This chapter addresses when an investor in a tax credit structure may apply the PAM, and the recognition, measurement and disclosure requirements when the PAM is elected and/or applied.



Subtopic 323-740 provides the guidance used to determine whether the PAM may be applied to a tax equity investment, and if so, how to apply it. A tax equity investment is an equity investment in an income tax credit structure through a limited liability entity (e.g. partnership, LLC) that is a pass-through (i.e. flow-through) entity for income tax purposes. The primary reason investors enter into tax equity investments is to receive income tax credits and other income tax benefits generated by the projects managed or invested in by the limited liability entities. [Section 6.2](#) provides additional information about the scope of the PAM.

The following decision tree highlights the main considerations and outcomes in Subtopic 323-740 for investors in tax equity investments.

6. Proportional amortization method



An investor in a tax equity structure may elect the PAM on a tax credit program-by-program basis (see [section 6.2](#)). For example, an investor may elect the PAM for the LIHTC program, but not the rehabilitation tax credit program.

Once the PAM has been elected for one or more tax credit programs, the investor determines whether the PAM qualifying criteria are met for each of its tax equity investments generating credits from those tax credit programs (see [section 6.3](#)). For example, if the PAM has been elected for the LIHTC program, tax equity investments generating tax credits from that program are individually evaluated to determine whether they meet the PAM qualifying criteria. The PAM cannot be applied to a tax equity investment unless the PAM qualifying criteria are met. If those criteria are not met, the tax equity investment is accounted for under Topic 323-30 or Topic 321, as appropriate (see [section 6.3.100](#)). If the investment meets the criteria, and the investor has elected to apply the PAM to the tax credit program, then the PAM must be applied to the investment.

Under the PAM, the cost of an investment is amortized in proportion to the income tax credits and other income tax benefits allocated to the investor each period. The amortization recognized during the period is calculated as follows:

$$\begin{array}{c}
 \text{Initial cost of the investment} \\
 \text{(less any residual value)}
 \end{array}
 \times
 \left(
 \begin{array}{c}
 \text{Total income tax credits and other income tax benefits allocated during the period} \\
 \div \\
 \text{Total expected income tax credits and other income tax benefits over the life of the investment}
 \end{array}
 \right)
 =
 \begin{array}{c}
 \text{Amortization of the cost of the investment}
 \end{array}$$

The amortization is recognized in income tax expense or benefit as an offset to the nonrefundable income tax credits and other income tax benefits (e.g. tax operating losses often attributable to tax depreciation) that the investor is allocated from the tax equity investment. [Section 6.4](#) provides additional information about the application of the PAM.

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 (see [section 6.5](#)).



New developments

The PAM has been available for qualifying investments in Qualified Affordable Housing Projects (LIHTC investments) as an alternative to either the cost or equity method of accounting since the issuance of ASU 2014-01. Given the economic similarities between LIHTC investments and other tax equity investments, stakeholders requested that the FASB consider expanding the availability of the PAM.

In response to those requests, the FASB issued ASU 2023-02, which does the following.

- **Expands the population of qualifying investments to which the PAM may be applied.** Instead of being limited to qualifying LIHTC investments, the PAM is applied to any tax equity investment that meets the PAM qualifying criteria (such as certain investments in renewable energy projects that generate income tax credits), provided the investor has elected the PAM for the tax credit program from which the investment generates credits (see [section 6.2](#)).
- **Clarifies the PAM qualifying criteria.** The clarifications (see [section 6.3.10](#)):
 - focus the criteria on ‘income’ tax credits and other ‘income’ tax benefits;
 - require the significant influence criterion to be evaluated in relation to the operations of the underlying project (see [section 6.3.20](#)); 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 (see [section 6.3.30](#)).
- **Provides 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 (see [section 6.2.10](#)).
- **Requires use of the flow-through method to account for income tax credits when the PAM is applied.** This is the case even if the investor has generally elected the deferral method of accounting for its other investment tax credits. [Section 4.2](#) discusses the flow-through and deferral methods of accounting for income tax credits.
- **Requires disclosures on an interim and annual basis for tax equity investments in tax credit programs for which the PAM is elected.** Certain disclosures are required regardless of whether the PAM is applied (see [section 6.5](#)).

The ASU also makes other amendments to Subtopic 323-740, some of which affect LIHTC investments for which the PAM was previously elected but not

6. Proportional amortization method

applied because the PAM qualifying criteria were not met. These amendments include:

- removing the guidance indicating that it may be appropriate to apply the cost method to a LIHTC investment;
- removing the example related to the impairment of a LIHTC investment accounted for using the equity method; and
- making the delayed equity contributions guidance (see [sections 6.3.60](#) and [6.4.50](#)) applicable only when the PAM is **applied** to a tax equity investment.

This chapter is prepared on the basis of the guidance in Subtopic 323-740, as amended by ASU 2023-02 (see [section 6.6](#) for the related effective date and transition guidance). Appendix B of KPMG Handbook, [Accounting for income taxes](#), provides guidance applicable prior to adoption of the ASU.

6.2 Scope

6.2.10 Overview

The PAM may be elected by equity investors in limited liability entities (e.g. partnerships, LLCs) that are pass-through (i.e. flow-through) entities for tax purposes and generate income tax credits and other income tax benefits from a tax credit program (i.e. tax equity investments). The primary reason investors enter into tax equity investments is to receive income tax credits and other income tax benefits generated by the projects managed or invested in by the limited liability entities. [323-740-05-1, 15-1A]

The following investments are not eligible for the PAM: [ASU 2023-02.BC11-BC12]

- an investment in an entity that is not a pass-through entity for income tax purposes;
- an investment classified as a debt investment;
- an investment that the investor is required to consolidate (see [chapters 2 – 4](#)); and
- an investment whose primary purpose is not to receive income tax credits and other income tax benefits.

An investor makes the election to apply the PAM to tax equity investments on a tax credit program-by-program basis. Only tax credit programs that provide the investor nonrefundable credits are eligible for the election. An investor that is allocated refundable tax credits accounts for those credits as non-income-tax-related benefits (see [section 6.2.20](#)).

An investor could elect to apply the PAM to qualifying investments that generate tax credits from one tax credit program (e.g. LIHTC program) and not make the election for investments that generate tax credits from a different tax credit program (e.g. rehabilitation tax credit program). [323-740-15-1A, 25-4]

While an investor may **elect** the PAM for a tax credit program from which its tax equity investment generates tax credits, it **applies** the PAM to account for that investment only if the investment meets the PAM qualifying criteria (see [section 6.3.10](#)). The accounting for a tax equity investment that is not consolidated and for which the investor does not apply the PAM (because it was not elected or the PAM qualifying criteria were not met) is discussed in [section 6.3.100](#) and involves the application of either Subtopic 323-30 or Topic 321, depending on the facts and circumstances.

Tax credits generated from multiple tax credit programs

One tax equity investment may generate tax credits from multiple projects, and one project may generate tax credits from multiple tax credit programs. The investor does not have to elect the PAM for all of the tax credit programs from which the tax equity investment generates tax credits for its tax equity investment to be eligible to apply the PAM. However, electing the PAM for less than all of those tax credit programs may affect the investor's ability to meet all of the PAM qualifying criteria (see [Example 6.3.10](#)). For that reason, an investor may want to consider electing the PAM for all tax credit programs from which it

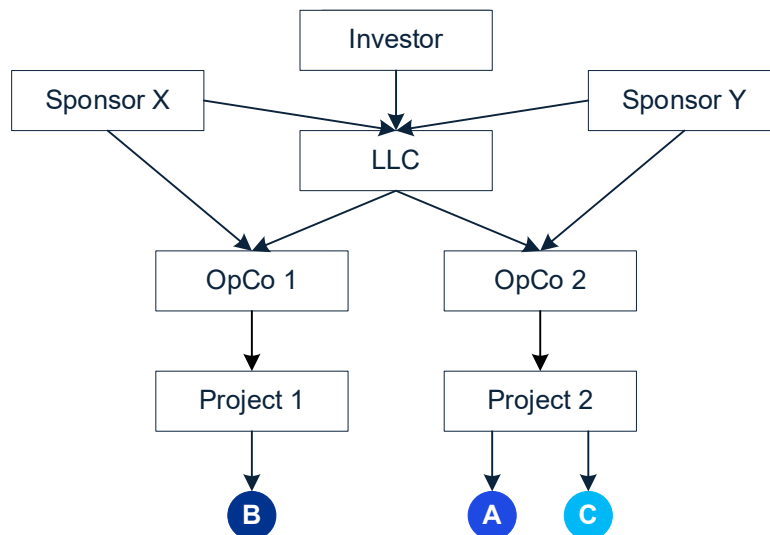
is allocated tax credits by its tax equity investments, particularly given that the PAM was designed to better reflect the overall economics behind investing in a tax equity investment.



Example 6.2.10

Tax equity investment involving multiple projects and tax credit programs

Investor and Sponsors X and Y invest in LLC (the tax equity investment) and LLC invests, along with Sponsors X and Y, in OpCos 1 and 2, respectively. OpCo 1 has one project generating nonrefundable income tax credits from Tax Credit Program B. OpCo 2 has one project generating nonrefundable income tax credits from Tax Credit Programs A and C.



Investor decides whether to elect the PAM for Tax Credit Programs A, B and C. Investor does not have to elect the PAM for all of the tax credit programs to be eligible to apply the PAM to its investment in LLC. However, electing the PAM for less than all of the tax credit programs may affect Investor's ability to meet one or more of the PAM qualifying criteria (see [Example 6.3.10](#)).

Once an investor has elected the PAM for a tax credit program, it must consistently: [\[323-740-15-1A, 25-4\]](#)

- determine whether the PAM qualifying criteria are met for its tax equity investments that receive tax credits from that program; and if so
- apply the PAM.

6.2.20 Eligibility of investments that generate refundable tax credits and other non-income-tax-related benefits

The substantially all and projected yield PAM qualifying criteria (see [sections 6.3.30](#) and [6.3.40](#), respectively) focus on the income tax credits and other income tax benefits generated by a tax equity investment to determine whether the primary purpose of the investment is to receive those income tax benefits. While generating non-income-tax-related benefits does not automatically result in an investor not meeting those criteria, these benefits could be significant enough to cause the investor to fail one or both of those criteria. Failing even one of the PAM qualifying criteria means the investor cannot apply the PAM to account for the tax equity investment.

Non-income-tax-related benefits include allocated refundable tax credits (see additional discussion below), a return from the project's operations (see [section 6.3.70](#)) and any proceeds from the sale or disposition of the investment (see [section 6.4.90](#)).

Refundable tax credits

It is important to understand whether tax credits generated by a tax equity investment are refundable because refundable tax credits are not income tax benefits even if the entity intends to use them to offset an income tax liability instead of receiving a cash refund. Although the claims for refundable tax credits are often filed in connection with an entity's income tax return, the refunds are not in the scope of Topic 740. Therefore, the benefit is not recorded as a reduction to income tax expense.

A refundable tax credit generated by a tax equity investment may become nonrefundable when allocated to the investor. The pass-through entity may agree, when the investors initially make their investment, to allocate the refundable tax credit to the investors. In this situation, we believe the refundability of the tax credit should be evaluated at the investor level instead of the pass-through entity level if there is evidence to support the agreement between the entity and its investors. This results in the tax credit being considered a nonrefundable tax credit for purposes of applying the PAM qualifying criteria and the PAM itself. All relevant evidence should be considered, including all of the agreements related to the tax equity investment and the related governance provisions, to determine whether the investee has in fact agreed to allocate the tax credit to the investors.

6.3 Recognition

6.3.10 PAM qualifying criteria

The PAM is applied to equity investments that generate income tax credits and other income tax benefits from a tax credit program for which the PAM has been elected when the following criteria are met. [[323-740 Glossary, 323-740-25-1](#)]

6. Proportional amortization method

Availability criterion	It is probable that the income tax credits allocable to the investor will be available. (For this purpose, probable means likely to occur.)
Significant influence criterion	The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project. (See section 6.3.20.)
Substantially all criterion	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). (See section 6.3.30.)
Projected yield criterion	The investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive (see section 6.3.40.)
Limited liability criterion	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.
<i>Source: Paragraph 323-740-25-1 of the Codification.</i>	

These criteria and the tax equity investments that meet them are commonly referred to as the PAM qualifying criteria and qualifying investments, respectively.

The PAM qualifying criteria are applied not only upon the investor's initial investment but also when a reevaluation circumstance occurs. As discussed in [section 6.3.80](#), there are any number of changes that could occur over the life of a tax equity investment that result in the reevaluation of the PAM qualifying criteria. From a practical perspective, investors should have procedures in place on an ongoing basis to determine whether a reevaluation of the PAM qualifying criteria is necessary. [\[323-740-25-1C\]](#)

The intent of the PAM qualifying criteria is to ensure that the principal purpose of the investment is to obtain income tax credits and other income tax benefits. Accordingly, when evaluating the PAM qualifying criteria, the investor should consider:

- whether each individual criterion is met; and
- whether the arrangement in totality supports the underlying premise that the investment was made primarily to obtain income tax benefits.

Excluding income tax benefits that are not more likely than not to be realized

Although not addressed in Subtopic 323-740, we believe an investor should exclude the following income tax benefits from the total income tax benefits used in the substantially all and projected yield criteria:

- those it does not expect to realize (i.e. those that are not expected to reduce cash taxes payable); and
- those that do not meet the recognition and measurement thresholds in accounting for income tax uncertainties.

For example, if it is not more likely than not that the investor will be able to realize some of the income tax benefits allocated to it (e.g. because of the expected character of the benefit as capital versus ordinary), that unused income tax benefit would be excluded from both the total income tax benefits and the total projected benefits used in evaluating the PAM qualifying criteria.

As another example, there may be some uncertainty related to whether a tax equity investment's project will meet all of the requirements to earn the tax credit. If a position that the project has met the requirements to earn the tax credit is not more likely than not to be sustained based on its technical merits given the facts and circumstances, that tax credit would be excluded from both the total income tax benefits and the total projected benefits used in evaluating the PAM qualifying criteria.

Any income tax benefit excluded for purposes of evaluating the PAM qualifying criteria should also be excluded from the following when the PAM is applied:

- the income tax benefits used to calculate investment amortization in the PAM schedule (see [section 6.4.10](#)); and
- any impairment analysis (see [section 6.4.80](#)).

The excluded income tax benefits should then be accounted for like any other tax benefit that is not more likely than not to be realized or tax position that is not more likely than not to be sustained based on its technical merits given the facts and circumstances. For example, in the period the investor generates a capital loss carryforward that is not considered an income tax benefit in applying the PAM (because it is not more likely than not to be realized), it would recognize a deferred tax asset and a valuation allowance under Topic 740. The recognition and measurement of deferred tax assets, valuation allowances and tax positions are all discussed in KPMG Handbook, [Accounting for income taxes](#).

[Section 6.4.60](#) discusses how to account for a change in estimate when applying the PAM, which may be necessary to the extent there is a change in the investor's estimate of the income tax benefits that are not more likely than not to be realized.

Excluding income tax benefits in excess of residual value

Situations may arise in which an investor expects an income tax benefit in one period to be recaptured in a later period. For example, the tax law may permit the investor to take benefits in excess of its tax basis in a qualified affordable housing project as the property leverages its assets or generates operating losses, but the benefits will be recaptured on dissolution or sale of the investment.

For purposes of applying the PAM, we believe the investor should take the same approach with the **excess** tax benefit (i.e. the benefit of tax deductions that reduce tax basis below the estimated residual value and that will be recaptured) as it takes with tax benefits it does not expect to realize. As such, any excess benefit should be excluded from both the income tax benefits and the total projected benefits used in evaluating the PAM qualifying criteria. The

excess benefit should also be excluded from the following when the PAM is applied:

- the income tax benefits used to calculate investment amortization in the PAM schedule (see [section 6.4.10](#)); and
- any impairment analysis (see [section 6.4.80](#)).

In the period the investor reports the excess tax benefit (which was not considered in the PAM schedule for that period because it will be recaptured), we believe the investor should:

- recognize the reduction in its current tax liability (consistent with its reporting on the tax return); and
- establish a deferred tax liability for the future recapture of the excess tax benefit when the tax basis is less than the estimated residual value.

Other transactions with the tax equity investee

There may be other transactions between the investor and tax equity investee. For example, the investor and tax equity investee may enter into a bank loan. These transactions are not considered when evaluating the PAM qualifying criteria provided all of the following conditions are met. [\[323-740-25-1B\]](#)

- The investor enters into those transactions as part of its normal-course business.
- The transactions' terms are consistent with those of arm's-length transactions.
- The transactions do not result in the investor obtaining significant influence over the tax equity investment's underlying projects.

These conditions are evaluated upon the investor's initial investment and upon the occurrence of any reevaluation circumstance (see [section 6.3.80](#)). [\[323-740-25-1C\]](#)

6.3.20 Significant influence criterion

To meet the significant influence criterion, the investor must conclude that it "does not have the ability to exercise significant influence over the operating and financial policies of the underlying project." The investor evaluates its ability to exercise significant influence over the project as a whole and, in doing so, considers the project's operations, financial decisions and related objectives. [\[323-740-25-1\(aa\), 25-1A\]](#)

For purposes of evaluating whether the significant influence criterion is met, the investor uses **qualitative** indicators of significant influence, including those in paragraphs 323-10-15-6 and 15-7. The primary purpose of these indicators is to determine whether an investor should apply the equity method to account for an investment. For that same purpose, the following presumptive quantitative thresholds are also considered when determining whether to apply the equity method. [\[323-10-15-6 – 15-11, 323-30-S99-1, 323-740-25-1A\]](#)

6. Proportional amortization method

- Significant influence is presumed to exist at or above the 20% ownership level of a corporate investment absent predominant evidence to the contrary.
- Significant influence is presumed not to exist below the 20% ownership level absent demonstration of having that ability.
- The equity method is applied to an investment in a partnership, unless the investor has virtually no influence over the partnership, which is presumed to be the case when the ownership interest is less than 3% to 5%.

While these are presumptive quantitative thresholds for purposes of determining whether an investor has significant influence and applies the equity method under Topic 323, we do not believe they are presumptive, in and of themselves, for determining whether the investor has significant influence over an underlying project in a tax equity investment. We believe this view is consistent with the EITF's discussion leading to the issuance of ASU 2014-01, where the focus was to evaluate significant influence based on:

- the rights of the limited partner investor under the arrangement; and
- whether the investor has the right to be involved in the investee's (or, after ASU 2023-02, the underlying project's) ongoing decision-making, including its operating and financial policies (see 'New developments' in [section 6.1](#)).

While the ownership percentage is not determinative or presumptive when evaluating the significant influence criterion, concentration of ownership in the tax equity investment should still be qualitatively considered by the investor. This is because the higher the ownership percentage, the more likely it may be that the investor has rights to be involved in the ongoing decision-making related to the underlying project.

Evaluating the investor's ability to exercise significant influence over the operating and financial policies of a tax equity investment's project depends on the facts and circumstances.

6.3.30 Substantially all criterion

To meet the substantially all criterion, the investor must conclude that substantially all of the projected benefits of the underlying project in a tax equity investment are from income tax credits and other income tax benefits. [323-740-25-1(aaa)]



The investor performs the substantially all test on a discounted basis using a discount rate consistent with the risks reflected in its cash flow assumptions when it decided to invest in the tax equity investment. [323-740-25-1(aaa)]

Income tax credits include only those in the scope of Topic 740. Excluding allocated refundable tax credits from the numerator of the substantially all test is consistent with the presentation of those credits in pretax income because their realization does not rely on the generation of an investor income tax liability. As discussed further in [section 6.2.20](#), we believe refundability is assessed from the investor perspective when a refundable tax credit generated by a tax equity investment becomes nonrefundable upon allocation to the investor provided there was agreement upon the initial investment that the tax credits would be allocated to the investor. [\[323-740-25-1\(aaa\)\]](#)

We believe income tax credits and other income tax benefits included in the numerator when evaluating the substantially all criterion include only those income tax benefits generated by tax credit programs for which the entity has elected to apply the PAM.

All projected benefits (the denominator of the substantially all test) include: [\[323-740-25-1\(aaa\)\]](#)

- income tax credits;
- other income tax benefits;
- non-income-tax-related benefits, including refundable tax credits; and
- any other projected benefits.

Non-income-tax-related benefits and any other projected benefits for the substantially all criterion include any non-income-tax-related cash flows, such as projected returns from the property's operations and/or the proceeds from the sale or disposition of the investment (see [sections 6.3.70](#) and [6.4.90](#), respectively). [\[323-740-25-1\(aaa\), 35-5\]](#)

Substantially all threshold

While Subtopic 323-740 does not define 'substantially all', that concept is used elsewhere in US GAAP and is usually interpreted to mean 90%. For example, Subtopic 842-10 (leases) includes implementation guidance that states that one acceptable approach to assessing a lease classification criterion is to conclude that 90% or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset. [\[842-10-55-2\(c\)\]](#)

In addition, during the EITF's deliberations leading to the issuance of ASU 2023-02, the EITF discussed whether to make changes to the substantially all threshold, which they acknowledged has generally been interpreted as 90% in practice. No changes were made to the threshold as a result of those discussions.

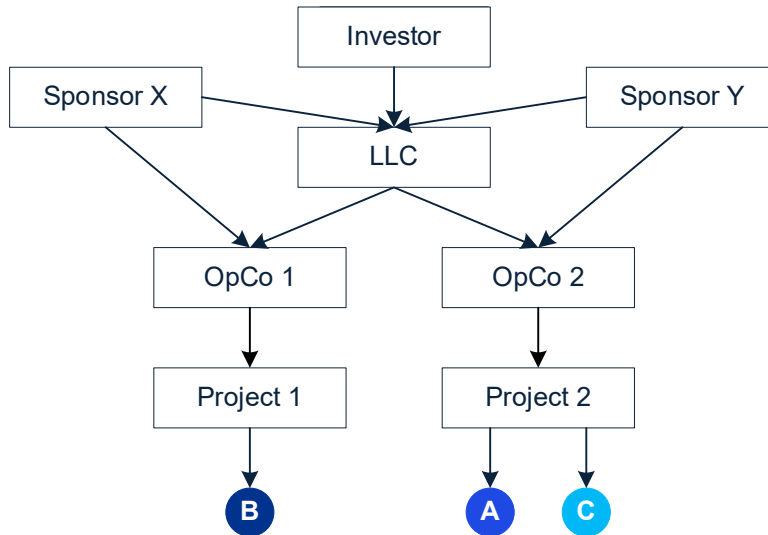
Based on how the substantially all threshold has been, and continues to be, applied in practice, we believe 90% should be used in applying the substantially all criterion.



Example 6.3.10

Evaluating the substantially all criterion in a tax equity investment with multiple projects and tax credit programs

This example is a continuation of [Example 6.2.10](#). The following represents Investor's investment in LLC (the tax equity investment).



Investor elects the PAM for Tax Credit Programs A and C, but not Tax Credit Program B.

The following are the projected benefits (on a discounted basis) that Investor expects to be allocated over the term of its investment in LLC related to each of the tax credit programs.

	\$	A	B	C	Total
Income tax credits	75,000	110,000	90,000	275,000	
Other income tax benefits	24,000	36,000	28,000	88,000	
Non-income-tax-related benefits	3,000	18,000	3,200	24,200	
Total benefits	102,000	164,000	121,200	387,200	

Investor determines that 56% $(\$75,000 + \$24,000 + \$90,000 + \$28,000) \div \$387,200$ of the total projected benefits it expects to be allocated from LLC over the term of the investment are income tax benefits attributable to Tax Credit Programs A and C (those for which the PAM has been elected). Because 56% is less than substantially all, the substantially all criterion is not met and Investor cannot apply the PAM to account for its investment in LLC.

If Investor wants to apply the PAM to its investment in LLC, it needs to elect the PAM for all of the tax credit programs from which it is allocated income tax credits and other income tax benefits. Doing so would result in 93.8% $(\$75,000 + \$24,000 + \$110,000 + \$36,000 + \$90,000 + \$28,000) \div \$387,200$ of the total

projected benefits Investor expects to be allocated from LLC over the term of the investment being income tax benefits attributable to tax credit programs for which it has elected the PAM. In that case, the substantially all criterion would be met.

6.3.40 Projected yield criterion

The investor's projected yield is positive at the date of the initial investment when the cash flows from the income tax credits and other income tax benefits are more than the amount of the initial investment. For this purpose, we believe the cash flows should be undiscounted. The reevaluation of this criterion is discussed in [section 6.3.80](#).

6.3.50 Income tax credits recognition

An investor must use the flow-through method to recognize income tax credits allocated by tax equity investments to which the PAM is applied. As such, the credits are recognized in the period in which they are allocated to the investor for tax purposes (i.e. the period in which they arise) and treated as a reduction of income taxes. Applying this method means the investor does **not**: [\[323-740-25-5, 30-1, 65-2\(f\), 740-10-25-46\]](#)

- recognize income tax credits in the financial statements in advance of the year in which they arise; nor
- immediately recognize upon its initial investment all the benefits expected to be provided by income tax credits over the investment's term – unless all of the credits are allocated to the investor upon its initial investment instead of over time.

In addition, the flow-through method is consistent with the PAM amortizing the initial cost of the investment based on the income tax credits and other income tax benefits **allocated** to the investor (see [section 6.4.10](#)). [Section 4.2](#) provides additional discussion about the flow-through method. [\[323-740-35-2\]](#)

The benefit of the income tax credit accounted for using the flow-through method is reflected as a reduction of income taxes.

Allocated income tax credits cannot be realized in current-year tax return

In many circumstances, allocation of an income tax credit to the investor and its inclusion in the tax return occur in the same period the investor realizes the tax benefit through a reduction in income taxes payable. However, situations may occur wherein the investor cannot realize the benefits in the current-year tax return. This results in operating loss or tax credit carryforwards for which the investor recognizes a deferred tax asset. The effects of doing so on applying the

PAM depend on whether it is more likely than not that the deferred tax asset will be realized. [740-10-30-5]

- **More likely than not.** Consider the carryforward as if it were a current income tax benefit in calculating the amortization of the investment (see [section 6.4.10](#)).
- **Not more likely than not.** Recognize a valuation allowance on the related deferred tax asset. Using only the remaining projected income tax benefits that are more likely than not to be realized (see [section 6.3.10](#)), consider whether the need for a valuation allowance results in:
 - the remaining investment being impaired (see [section 6.4.80](#)); and/or
 - the PAM qualifying criteria no longer being met (e.g. the projected yield has changed from positive to negative) (see [section 6.3.80](#)).

6.3.60 Delayed equity contributions

As part of its initial investment, the investor in a tax equity structure may commit to future funding of an additional investment (i.e. make a delayed equity contribution). The accounting for delayed equity contributions depends on whether the investor applies the PAM to account for the investment.

Investor applies the PAM

A commitment for a delayed equity contribution is recognized as a liability if fulfilling it is unconditional and legally binding. In addition, if fulfilling the commitment is contingent on a future event, the liability is recognized if and when the event becomes probable of occurring. For this purpose, probable means likely to occur. If fulfilling a delayed equity contribution is unconditional and legally binding, but the amount of the contribution is contingent on a future event, we believe the investor should measure the liability based on its best estimate of the contribution it expects to make. [Section 6.4.60](#) discusses the effects of changing an estimate used in applying the PAM. [323-740 Glossary, 323-740-25-3]

Based on the recognition guidance for delayed equity contributions, and depending on the facts and circumstances, a liability for the contribution could be recognized on the date of the initial investment or at some later point in time during the investment's term. Applying the PAM when a delayed equity contribution is recognized after the initial investment is discussed in [section 6.4.50](#).

Recognizing a liability for a delayed equity contribution increases the cost basis of the investment that is subject to the PAM. Recognizing both a liability and an increase in the cost basis of the investment is sometimes referred to as recognizing the delayed equity contribution on a gross basis. [323-740-25-3]

If a contingent delayed equity contribution is not recognized because fulfilling it is not probable, the future cost basis and future income tax credits (and other

income tax benefits) associated with that contribution are not considered in applying the PAM.

The probability of fulfilling a delayed equity contribution is reevaluated at the end of each reporting period. If the likelihood of fulfilling the contribution changes from:

- **not probable to probable**, a liability is recognized with a corresponding increase to the carrying amount of the investment; or
- **probable to not probable**, the related liability is derecognized with a corresponding decrease to the carrying amount of the investment.

As discussed in [section 6.3.80](#), the PAM qualifying criteria are reevaluated when the probability of making a contingent delayed equity contribution changes. In addition, the investor considers whether an impairment analysis is necessary (see [section 6.4.80](#)). If the PAM qualifying criteria continue to be met, the necessary adjustments are made to the PAM schedule at that point in time. When the probability changes from not probable to probable, the adjustments involve incorporating the contribution along with any associated income tax benefits into the PAM schedule (see [section 6.4.50](#)). When the probability changes from probable to not probable, the adjustments involve removing the contribution along with any associated income tax benefits from the PAM schedule.

Investor does not apply the PAM

When the investor does not apply the PAM, delayed equity contributions are accounted for using the model otherwise applied to account for the tax equity investment and no liability is recognized.

6.3.70 Non-income-tax-related benefits

When the PAM is applied, any non-income-tax-related benefits/income resulting from the operations of the tax equity investment are: [\[323-740-35-5\]](#)

- recognized when they are realized or realizable; and
- presented in pretax earnings.

Accounting for the sale or disposition of the investment is discussed in [section 6.4.90](#).

The nature of non-income-tax-related benefits is discussed in [section 6.2.20](#).

6.3.80 Reevaluation circumstances

An investor reevaluates whether the PAM qualifying criteria are met when one or both of the following change, and that change might affect whether the criteria are met: [\[323-740-25-1C\]](#)

6. Proportional amortization method

- the nature of the investment; or
- the relationship with the underlying project.

We believe these changes (or triggers) should also result in the investor reevaluating whether a tax equity investment falls in the scope of Subtopic 323-740 (see [section 6.2.10](#)). For example, if the tax equity investment is no longer a pass-through entity for tax purposes, it is no longer in the scope of Subtopic 323-740. [\[323-740-15-1A\]](#)

The following are examples of changes that may affect whether the PAM qualifying criteria are met when a reevaluation of those criteria is performed.

Change	Criteria potentially affected
The project no longer qualifies for the income tax credits.	Availability criterion
Rights allowing the investor to exercise significant influence have been triggered as a result of contingent events.	Significant influence criterion
The investor has decided to sell the investment.	Substantially all and/or projected yield criteria
The investor concludes it is not more likely than not to realize some or all of the tax benefits.	
The probability of the future event on which a contingent delayed equity contribution depends changes from probable to not probable or vice versa.	
The investor changes its expectation as to whether the tax equity investee will sell a transferrable credit.	
A change occurs in the estimate of income tax credits or other income tax benefits expected in the future.	
The investor's liability is no longer limited to its capital investment for legal or tax purposes.	Limited liability criterion

When reevaluating the substantially all and projected yield criteria (see [sections 6.3.30](#) and [6.3.40](#), respectively), we believe the investor should consider the full term of the investment and not just the remaining term. For example, we believe the income tax credits, other income tax benefits and non-income-tax-related benefits used in evaluating those criteria should reflect actual amounts through the reevaluation date and estimated amounts from the reevaluation date through the end of the investment's term.

We believe the reevaluation of the availability, significant influence and limited liability criteria should be based on the facts and circumstances at the point in time the reevaluation is performed.

If any one of the PAM qualifying criteria are no longer met upon reevaluation, the investor discontinues applying the PAM (see [section 6.3.90](#)).

Change in tax law

When there is a change in tax law that may affect whether an investment qualifies for the PAM, we believe an investor should reevaluate whether the PAM qualifying criteria are met and whether the investment is in the scope of Subtopic 323-740.

We believe the investor first reevaluates whether its investment meets the PAM qualifying criteria based on its revised expectation of the income tax benefits. Next, the investor assesses the investment for impairment by determining whether it is more likely than not that the investment is not realizable (see [section 6.4.80](#)).

If the change in tax law is the sole reason for the PAM qualifying criteria no longer being met or the investment being impaired, we believe the resulting adjustment is recognized with the other effects of the change in tax law – in income tax expense (benefit) from continuing operations.

[Section 6.4.70](#) discusses how an investor might revise its PAM schedule when there has been a change in tax law.

6.3.90 Discontinuing application of the PAM

As discussed in [section 6.3.80](#), an investor reevaluates in certain circumstances whether the PAM qualifying criteria are met for a tax equity investment. In addition, as discussed in [section 6.4.80](#), the recognition of an impairment might result in a tax equity investment no longer meeting all of the PAM qualifying criteria.

When a tax equity investment accounted for using the PAM no longer meets the PAM qualifying criteria, the investor prospectively accounts for the investment using the applicable accounting model (see [chapter 5](#)).

6.3.100 Tax equity investments to which the PAM is not applied

The PAM may not be applied to a tax equity investment because: [\[323-740-25-1, 25-4\]](#)

- the investor has not elected the PAM for the underlying tax credit program; or
- the investor has elected the PAM for the underlying tax credit program, but the PAM qualifying criteria have not been met.

As discussed further in [chapter 5](#), when a tax equity investment is not consolidated and the PAM has not been applied, the investor determines whether to account for the investment under Subtopic 323-30 or Topic 321. [\[ASU 2023-02.Summary, ASU 2023-02.BC23\]](#)

6.3.110 Tax equity investments acquired in a business combination

Topic 805 is applied to account for a business combination. Under Topic 805, a tax equity investment is recognized at its fair value on the acquisition date.

For ongoing accounting purposes, the acquirer/investor considers whether it has elected, or will elect (in the absence of a previous election), the PAM for the tax credit program(s) from which the tax equity investment generates income tax credits. If the PAM is elected, we believe the acquirer/investor determines whether the PAM qualifying criteria are met by only considering income tax benefits and total projected benefits expected to be generated after the acquisition date.

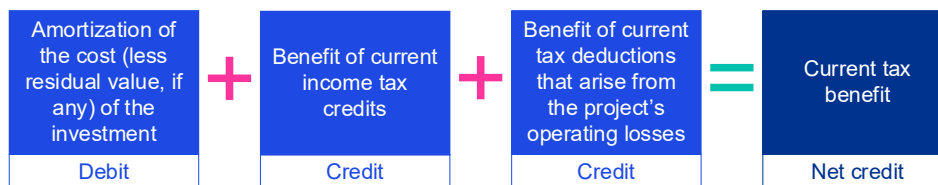
If the PAM is elected for the relevant tax credit program and the PAM qualifying criteria are met, the acquirer/investor applies the PAM to account for the tax equity investment after the acquisition date and no deferred taxes are provided on the basis difference of the investment (see [section 6.4.20](#)).

If the tax equity investment is not consolidated and the PAM has not been applied (because it was not elected or the PAM qualifying criteria were not met), the acquirer/investor determines whether Subtopic 323-30 or Topic 321 is used to account for the investment after the acquisition date (see [section 6.3.100](#)). In addition, deferred taxes are recognized for the investment as necessary (see section 6 of KPMG Handbook, [Accounting for income taxes](#)).

6.4 Initial and subsequent measurement

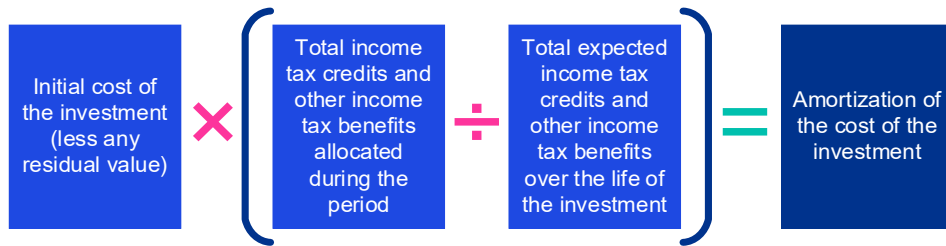
6.4.10 Applying the PAM

Investors applying the PAM calculate the current tax expense (benefit) for a tax equity investment as follows. [\[323-740-45-2\]](#)



The cost of the investment, less any expected residual value (undiscounted), is amortized in proportion to (and over the same period as) the total income tax credits and other income tax benefits expected to be allocated to the investor. [\[323-740-35-2, 35-5\]](#)

6. Proportional amortization method



The investor recognizes the income tax credits and other income tax benefits in current tax expense and no deferred taxes are provided on the basis difference of the investment (see [section 6.4.20](#)). [323-740-45-2]

While Subtopic 323-740 does not indicate how a tax equity investment accounted for using the PAM is classified on the balance sheet, we believe the investment (although similar) does not represent a deferred tax asset. Under this view, entities generally should classify such investments like other investments in the scope of Topic 323. [ASU 2014-01.BC17]



Example 6.4.10

Application of the PAM to a tax equity investment

On January 1, Year 1, Investor pays \$255,000 to provide 5% of the equity capital for Tax Equity Investment (TEI). TEI is a limited liability partnership and a pass-through entity for tax purposes. TEI manages a project that generates income tax credits and other income tax benefits. Total project costs are estimated to be \$5 million.

Investor has elected to apply the PAM to the tax program that generates the income tax credits earned by TEI. Investor evaluates the PAM qualifying criteria and determines that its investment in TEI satisfies those criteria.

The following are additional terms of the investment and other information pertinent to Investor's accounting for it.

Terms and other information	TEI investment
Timing of cash flows	Initial investment occurs on January 1, Year 1 and other cash flows occur at the end of each year thereafter.
Depreciable life	10 years for both book and tax purposes (for ease of illustration)
Depreciation method	Straight-line for both book and tax purposes (for ease of illustration)
Timing of income tax credits received by TEI	Over a four-year period beginning in Year 1
Annual income tax credit allocation to Investor	\$50,000 per year for the first four years, with the first allocation at the end of Year 1
Investor's tax rate	25%

6. Proportional amortization method

Terms and other information	TEI investment
Estimated residual investment	None (for ease of illustration)
Income tax losses of TEI passed on to Investor	\$25,000 per year, for ease of illustration, based on the depreciation expense attributable to Investor ($(\$5,000,000 \text{ total project costs} \times 5\%) \div 10 \text{ years}$)
Estimated cash returns from the underlying project's operations (i.e. cash returns not related to income tax credits or other income tax benefits)	\$500 per year (based on a fixed percentage of the cash generated by the project over its life), for a total of \$5,000 over the project's 10-year life
Recapture provisions	The income tax credits are not subject to recapture.
Put option	After 10 years, Investor has the option to require TEI's sponsor to purchase its equity interest for a nominal amount (which is assumed to be zero for ease of illustration). Investor expects to exercise this option.

In addition, the income tax credits do not reduce the tax basis of TEI's project costs.

The following PAM schedule illustrates application of the PAM to Investor's investment in TEI.

6. Proportional amortization method

\$	A	B	C	D	E	F	G	H	I
Year	Beg. net investmt.	Amort. of investmt.	End. net investmt.	Inc. tax credits	Investor share of project tax losses	Other inc. tax ben. from tax losses	Inc. tax credits and other inc. tax ben.	Inc. tax credits and oth. inc. tax ben., net of amort.	Non-inc.-tax-related cash returns
1	255,000	54,643	200,357	50,000	25,000	6,250	56,250	1,607	500
2	200,357	54,643	145,714	50,000	25,000	6,250	56,250	1,607	500
3	145,714	54,643	91,071	50,000	25,000	6,250	56,250	1,607	500
4	91,071	54,643	36,428	50,000	25,000	6,250	56,250	1,607	500
5	36,428	6,071	30,357	-	25,000	6,250	6,250	179	500
6	30,357	6,071	24,286	-	25,000	6,250	6,250	179	500
7	24,286	6,071	18,215	-	25,000	6,250	6,250	179	500
8	18,215	6,071	12,144	-	25,000	6,250	6,250	179	500
9	12,144	6,071	6,073	-	25,000	6,250	6,250	179	500
10	6,073	6,073	0	-	25,000	6,250	6,250	177	500
Total		255,000		200,000	250,000	62,500	262,500	7,500	5,000

Notes:

- A. For Year 1, the initial cost of the investment. For Years 2-10, the prior year's ending net investment (column C).
- B. Calculated based on the initial cost of the investment multiplied by the ratio of the current year's income tax credits and other income tax benefits to the total income tax credits and other income tax benefits for the 10-year period (column G). The amortization for Year 1: $\$255,000 \times (\$56,250 \div \$262,500) = \$54,643$.
- C. The beginning net investment for the year (column A) less the amortization of the investment for the year (column B).
- D. The income tax credits of \$50,000 per year allocated to Investor for the first four years.
- E. Investor's share of the total project costs depreciated over the project's useful life: $(\$5,000,000 \times 5\%) \div 10 = \$25,000$. For ease of illustration, Investor's share of the project tax losses is assumed to be entirely attributable to depreciation expense.
- F. The tax effects of Investor's share of project tax losses (column E): $\$25,000 \times 25\% = \$6,250$.
- G. The sum of the income tax credits for the year (column D) and the other income tax benefits from tax losses for the year (column F).
- H. The excess of the income tax credits and other income tax benefits for the year (column G) over the amortization of the investment for the year (column B).
- I. Investor's share of the non-income-tax-related cash returns expected to be generated by the underlying project's operations, which are \$500 per year over the life of the project.

6. Proportional amortization method

The following journal entries illustrate the financial statement effects of Investor's investment in TEI for Year 1, including the effects of applying the PAM to account for that investment.

	<i>Debit</i>	<i>Credit</i>
Investment in TEI	255,000	
Cash		255,000
<i>To recognize initial investment on January 1, Year 1.</i>		
Income taxes payable	56,250	
Current income tax benefit		1,607
Investment in TEI		54,643
<i>To recognize the income tax credits allocated to Investor in Year 1 and the effects of applying the PAM.</i>		
Cash	500	
Pretax earnings ¹		500
<i>To recognize the cash returns from the underlying project's operations (i.e. cash returns not related to income tax credits or other income tax benefits).</i>		
Note:		
1. The cash returns from the underlying project's operations are often recognized in 'Other income/expense'.		

6.4.20 Deferred taxes not recognized under the PAM

In [Example 6.4.10](#), the investor pays \$255,000 for \$262,500 of total income tax benefits. Under the PAM, because the investment is amortized in proportion to the total of the income tax credits and other income tax benefits, approximately \$0.97 ($\$255,000 \div \$262,500$) of investment amortization is recognized for every \$1 of income tax benefit.

All of the income tax benefits are recognized as they are reflected on the tax return for the period. No deferred taxes are recognized on the basis difference of the investment because the book basis of the investment is amortized, in part, as the income tax benefits are allocated to the investor (i.e. there is book basis **assigned** to the income tax benefits).

The source of this basis difference is analogous to the basis difference that arises when an entity purchases only income tax benefits as addressed in paragraphs 740-10-55-199 to 55-201 (i.e. the **deferred credit** equal to the difference between the undiscounted income tax benefit and the price paid) (see paragraph 10.004 of KPMG Handbook, [Accounting for income taxes](#)). In both situations, the basis difference is expected to be recovered or settled through realization of income tax benefits (and not pretax income) even though the carrying amount is not characterized as a deferred tax item in the financial

statements. Accordingly, as illustrated in [Example 6.4.10](#), no deferred taxes are recognized under the PAM. [740-10-25-50 – 25-52, 45-22]

6.4.30 Estimated annual effective tax rate and rate reconciliation under the PAM

Because no deferred taxes are recognized under the PAM (see [section 6.4.20](#)), all three components of income tax expense (investment amortization, income tax credits and other income tax benefits) result in reconciling items in the investor's effective tax rate reconciliation (see paragraph 9.086 in KPMG Handbook, [Accounting for income taxes](#)).

The net effect on income tax expense is included in the investor's estimated annual effective tax rate used for interim reporting.

6.4.40 Practical expedient to calculating proportional amortization

A practical expedient allows an investor to amortize the initial cost of the investment in proportion to only the income tax credits allocated to it, but only if the investor reasonably expects that the result will produce a measurement that is substantially similar to the result of applying the PAM. [323-740-35-4]

Evaluating *substantially similar*

When evaluating the substantial similarity between the measurements from applying the PAM and the practical expedient, we believe the net effect of each on income tax expense may be used. However, this evaluation requires judgment and depends on the individual facts and circumstances, such as the difference between the expected total benefit period and the credit period, and the extent to which some of the tax benefits may not be more likely than not to be realized.

If applying the practical expedient would not be substantially similar to the PAM, the investor must apply the PAM if elected as its accounting policy for the underlying tax credit program when the PAM qualifying criteria have been met. [323-740-25-1A, 25-4, 35-4]

Consistent application of the practical expedient

Subtopic 323-740 does not address whether an investor that elects to apply the practical expedient to one qualifying tax equity investment must consistently apply the practical expedient to all qualifying tax equity investments when substantial similarity exists.

We believe it would not be appropriate for the investor to simply choose between the practical expedient and the PAM on an investment-by-investment basis. Instead, we believe an investor that elects to apply the practical expedient

should do so on a tax credit program-by-program basis. If the investor elects to apply the practical expedient to a tax credit program, the practical expedient is evaluated for all qualifying tax equity investments generating income tax credits from that program. If substantial similarity exists between the practical expedient and the PAM for a particular tax equity investment, the practical expedient is used to account for that investment. If substantial similarity does not exist, then the PAM is used to account for that investment.

Recognition of deferred taxes

Subtopic 323-740 does not illustrate the practical expedient, nor does it specifically address the need to recognize deferred taxes if the practical expedient is applied. In the absence of guidance, we believe the investor should record deferred taxes on the basis difference of the investment, because the book investment amortization is only based on income tax credits and is not based on the income tax benefits other than tax credits. This is in contrast to no deferred taxes being recognized under the PAM (see [section 6.4.20](#)).

The book-tax difference arises because the practical expedient amortizes the investment's carrying amount for financial reporting purposes in different periods than the reduction of tax basis due to the tax deductions that will be taken on the tax return. As a result, the investor recognizes the deferred tax effects during the credit period or tax loss period that will reverse after the amortization period and the tax loss period.

In summary, we believe investors that apply the practical expedient should recognize deferred taxes on the basis difference of the tax equity investment to reflect the financial statement effects of the tax benefits from tax operating losses related primarily to depreciation that occurs before or after the credit period.

The recognition of deferred taxes under the practical expedient is illustrated in the following example.



Example 6.4.20

Comparison of measurement using the practical expedient to measurement under the PAM

Paragraphs 323-740-55-2 to 55-6 illustrate applying the PAM to a tax equity investment with the following facts.

Investor	
Amount and timing of initial investment	\$100,000 at the beginning of Year 1
Limited partner ownership interest	5%
Basis reduction	There is no reduction of tax basis as a result of the income tax credits
First year of eligibility for the tax credit	Year 1
Annual tax credit allocation	\$8,000 per year for 10 years

6. Proportional amortization method

Investor	
Investor's tax rate	40%
Timing of cash flows	End of each year, except for initial investment
Estimated residual investment	None (for ease of illustration)
Recapture	None, because all requirements are met to retain allocable tax credits
Income tax losses of project passed on to investor	Limited to the investor's share of depreciation expense (for ease of illustration), with the cumulative losses not to exceed \$100,000 (the initial investment amount)

Project	
Cost and financing	\$4,000,000 (financed with 50% equity and 50% debt)
Depreciable life	27.5 years for both book and tax purposes (for ease of illustration)
Depreciation method	Straight-line for both book and tax purposes (for ease of illustration)
Non-income-tax-related income	None; the project is expected to operate with break-even pretax cash flows during the first 15 years of operations
Income tax losses passed on to investors	Limited to depreciation expense (for ease of illustration)

The following table illustrates how the application of the practical expedient compares to the application of the PAM without the practical expedient using the facts above. This example is for illustrative purposes only and is not intended to represent a conclusion that Investor would qualify for the practical expedient given these facts. The practical expedient may only be applied if Investor reasonably expects it would produce a measurement substantially similar to the PAM. Making this determination requires judgment and will depend on the individual facts and circumstances.

6. Proportional amortization method

Year	A	B	C	D	E	F	G	H	I	J	K	L	M	N
Year	Beginning net investment	Amortization of investment	Ending net investment	Income tax credits	Investor share of project tax losses	Other income tax benefits from tax losses	Income tax credits and other income tax benefits	Total current tax benefit (expense)	Tax basis of investment	Deductible temporary difference	Deferred tax asset	Deferred tax benefit (expense)	Total tax benefit (expense)	PAM total tax benefit (expense)
1	100,000	10,000	90,000	8,000	7,273	2,909	10,909	909	92,727	2,727	1,091	1,091	2,000	1,818
2	90,000	10,000	80,000	8,000	7,273	2,909	10,909	909	85,454	5,454	2,182	1,091	2,000	1,818
3	80,000	10,000	70,000	8,000	7,273	2,910	10,910	910	78,181	8,181	3,272	1,090	2,000	1,818
4	70,000	10,000	60,000	8,000	7,273	2,909	10,909	909	70,908	10,908	4,363	1,091	2,000	1,818
5	60,000	10,000	50,000	8,000	7,273	2,909	10,909	909	63,635	13,635	5,454	1,091	2,000	1,818
6	50,000	10,000	40,000	8,000	7,273	2,909	10,909	909	56,362	16,362	6,545	1,091	2,000	1,818
7	40,000	10,000	30,000	8,000	7,273	2,909	10,909	909	49,089	19,089	7,636	1,091	2,000	1,818
8	30,000	10,000	20,000	8,000	7,273	2,910	10,910	910	41,816	21,816	8,726	1,090	2,000	1,818
9	20,000	10,000	10,000	8,000	7,273	2,909	10,909	909	34,543	24,543	9,817	1,091	2,000	1,818
10	10,000	10,000	0	8,000	7,273	2,909	10,909	909	27,270	27,270	10,908	1,091	2,000	1,818
11	-	-	-	-	7,273	2,909	2,909	2,909	19,997	19,997	7,999	(2,909)	0	485
12	-	-	-	-	7,273	2,909	2,909	2,909	12,724	12,724	5,090	(2,909)	0	485
13	-	-	-	-	7,273	2,910	2,910	2,910	5,451	5,451	2,180	(2,910)	0	485
14	-	-	-	-	5,451	2,180	2,180	2,180	0	0	0	(2,180)	0	365
Total		100,000		80,000	100,000	40,000	120,000	20,000				0	20,000	20,000

Notes:

- A. For Year 1, the initial cost of the investment. For Years 2-10, the prior year's ending net investment (column C).
- B. Calculated based on the initial cost of the investment multiplied by the ratio of the current year's income tax credits to the total income tax credits (column D). The amortization for Year 1: $\$100,000 \times (\$8,000 \div \$80,000) = \$10,000$.
- C. The beginning net investment for the year (column A) less the amortization of the investment for the year (column B).
- D. The income tax credits of \$8,000 per year allocated to Investor for the first 10 years.
- E. For Years 1-13, Investor's share of the total project costs depreciated over the project's useful life: $(\$4,000,000 \times 5\%) \div 27.5 = \$7,273$. For Year 14, the difference between the initial cost of the investment and the cumulative amount of Investor's share of project cost depreciation (which is capped at the initial cost of the investment): $\$100,000 - (\$7,273 \times 13) = \$5,451$. For ease of illustration, Investor's share of the project tax losses is assumed to be entirely attributable to depreciation expense.
- F. The tax effects of Investor's share of project tax losses (column E). For Year 1: $\$7,273 \times 40\% = \$2,909$.

6. Proportional amortization method

- G. The sum of the income tax credits for the year (column D) and the other income tax benefits from tax losses for the year (column F).
- H. The excess of the income tax credits and other income tax benefits for the year (column G) over the investment amortization for the year (column B).
- I. For Year 1, the initial cost of the investment less Investor's share of the project tax losses for the year (column E). For Years 2-14, the prior year's tax basis of the investment less Investor's share of the project tax losses for the year (column E).
- J. The excess of the tax basis of the investment (column I) over the ending net investment (column C) (i.e. the book basis of the investment).
- K. The tax effects of the deductible temporary difference (column J). For Year 1: $\$2,727 \times 40\% = \$1,091$.
- L. For Years 1-10, the increase in the deferred tax asset for each year (column K). For Years 11-14, the decrease in the deferred tax asset for each year.
- M. The sum of the total current tax benefit (expense) for the year (column H) and the deferred tax benefit (expense) for the year (column L).
- N. The income tax credits and other income tax benefits, net of amortization from the PAM schedule included in paragraph 323-740-55-5.

6. Proportional amortization method

In this example, Investor pays \$100,000 for \$120,000 of total income tax benefits that comprise \$80,000 of income tax credits (\$10,000 per year for eight years) and \$40,000 of other income tax benefits from tax losses (resulting from deducting operating losses up to the investor's \$100,000 investment, assuming a 40% tax rate). The following table summarizes the measurements produced by the PAM versus the practical expedient.

	Under the PAM	Under the practical expedient
Investment amortization produced for \$1 of income tax benefit (PAM) or credit (practical expedient)	Approximately \$0.83 (\$100,000 ÷ \$120,000) of investment amortization is produced for every \$1 of income tax benefit .	Approximately \$1.25 (\$100,000 ÷ \$80,000) of investment amortization is produced for every \$1 of income tax credit .
Total income tax benefit (expense) produced	Years 1-10: \$1,818 per year Years 11-13: \$485 per year Year 14: \$365	Years 1-10: \$2,000 per year Years 11-14: \$0

6.4.50 Delayed equity contributions recognized after initial investment

As part of its initial investment, the investor in a tax equity structure may commit to future funding of an additional investment (i.e. make a delayed equity contribution) (see [section 6.3.60](#)). When the investor applies the PAM, the liability for the commitment is recognized at the same time as or after the initial investment, depending on the facts and circumstances. [\[323-740-25-3\]](#)

When the investor applies the PAM and a delayed equity contribution is recognized after the tax equity investment's initial funding, the PAM qualifying criteria are evaluated (or reevaluated) to determine whether they are or continue to be met (see [section 6.3.80](#)). In addition, the investor considers whether an impairment analysis is necessary (see [section 6.4.80](#)).

If the PAM qualifying criteria are or continue to be met after considering recognition of the delayed equity contribution, the contribution becomes subject to the PAM, and any associated income tax benefits are incorporated into the PAM schedule for determining amortization of the investment at that time. However, Subtopic 323-740 does not address how to apply the PAM to an additional investment made after the initial investment. For this purpose, we believe it would be acceptable for an investor to either:

- add the incremental cost basis of the commitment to the remaining cost basis of the existing investment and adjust the PAM schedule prospectively as a change in estimate; or
- account for the incremental cost basis of the commitment individually with its own PAM schedule.

While either approach is acceptable, we believe the first approach is more consistent with the treatment of these investments under the tax law as a single investment. Both of these approaches are illustrated in the following example.



Example 6.4.30

Application of the PAM when a delayed equity contribution is recognized after initial funding

The same facts are used in this example as are used in [Example 6.4.10](#). In addition, on January 1, Year 2, Investor makes a delayed equity contribution to TEI that was not expected when Investor made its initial investment. The following are the terms of the delayed equity contribution and other information pertinent to Investor's accounting for it.

Terms and other information	TEI investment
Delayed equity contribution	\$45,000 at the beginning of Year 2
Timing of additional income tax credits received by TEI	Over a four-year period beginning in Year 2
Additional annual income tax credit allocation to Investor	\$9,000 per year for Years 2-5 with the first allocation at the end of Year 2
Additional income tax losses of TEI passed on to Investor	\$5,000 per year, for ease of illustration, based on the depreciation expense attributable to Investor ($(\$900,000 \text{ additional project costs} \times 5\%) \div 9 \text{ years}$)
Additional non-income-tax-related benefits expected	None

Investor re-evaluates the PAM qualifying criteria and determines that its investment in TEI continues to satisfy those criteria.

Below are examples of the two methods we believe could be used to account for Investor's delayed equity contribution under the PAM. The results of applying both methods are similar.

6. Proportional amortization method

Method A: Add the additional contribution to the remaining cost of the existing investment

\$	A	B	C	D	E	F	G	H	I
Year	Beg. net investmt.	Amort. of investmt.	End. net investmt.	Inc. tax credits	Investor share of project tax losses	Other inc. tax ben. from tax losses	Inc. tax credits and oth. inc. tax ben.	Inc. tax credits and oth. inc. tax ben., net of amort.	Non-inc.-tax-related cash returns
1	255,000	54,643	200,357	50,000	25,000	6,250	56,250	1,607	500
2	245,357	64,364	180,993	59,000	30,000	7,500	66,500	2,136	500
3	180,993	64,364	116,629	59,000	30,000	7,500	66,500	2,136	500
4	116,629	64,364	52,265	59,000	30,000	7,500	66,500	2,136	500
5	52,265	15,970	36,295	9,000	30,000	7,500	16,500	530	500
6	36,295	7,259	29,036	-	30,000	7,500	7,500	241	500
7	29,036	7,259	21,777	-	30,000	7,500	7,500	241	500
8	21,777	7,259	14,518	-	30,000	7,500	7,500	241	500
9	14,518	7,259	7,259	-	30,000	7,500	7,500	241	500
10	7,259	7,259	0	-	30,000	7,500	7,500	241	500
Total		300,000		236,000	295,000	73,750	309,750	9,750	5,000
Years 2-10							253,500		

Notes:

- A. For Year 1, the initial cost of the investment. For Year 2, the ending net investment (column C) for Year 1 plus the delayed equity contribution made by Investor at the beginning of Year 2: $\$200,357 + \$45,000 = \$245,357$. For Years 3-10, the prior year's ending net investment (column C).
- B. For Year 1, see [Example 6.4.10](#). For Years 2-10, calculated based on the beginning net investment for Year 2 (column A for Year 2) multiplied by the ratio of the current year's income tax credits and other income tax benefits to the total remaining income tax credits and other income tax benefits for Years 2-10 (column G). The amortization for Year 2: $\$245,357 \times (\$66,500 \div \$253,500) = \$64,364$.
- C. The beginning net investment for the year (column A) less the amortization of the investment for the year (column B).
- D. The income tax credits of \$50,000 per year allocated to Investor for Years 1-4 and an additional \$9,000 per year for Years 2-5.
- E. For Year 1, Investor's share of the initial total project costs depreciated over the project's useful life: $(\$5,000,000 \times 5\%) \div 10 = \$25,000$. For Years 2-10, Investor's share of the revised total project costs less its share of the project cost depreciation for Year 1, depreciated over the project's remaining useful life: $((\$5,900,000 \times 5\%) - \$25,000) \div 9 = \$30,000$. For ease of illustration, Investor's share of the project tax losses is assumed to be entirely attributable to depreciation expense.
- F. The tax effects of Investor's share of project tax losses (column E). For Year 1: $\$25,000 \times 25\% = \$6,250$.
- G. The sum of the income tax credits for the year (column D) and the other income tax benefits from tax losses for the year (column F).
- H. The excess of the income tax credits and other income tax benefits for the year (column G) over the amortization of the investment for the year (column B).
- I. Investor's share of the non-income-tax-related cash returns expected to be generated by the underlying project's operations, which are \$500 per year over the life of the project.

6. Proportional amortization method

Method B: Treat the additional contribution as a separate investment*Separate (\$45,000) investment schedule*

\$	A	B	C	D	E	F	G	H	I
Year	Beg. net investmt.	Amort. of investmt.	End. net investmt.	Inc. tax credits	Investor share of project tax losses	Other inc. tax. ben. from tax losses	Inc. tax credits and oth. inc. tax ben.	Inc. tax credits and oth. inc. tax ben., net of amort.	Non-inc.-tax-related cash returns
1	-	-	-	-	-	-	-	-	-
2	45,000	9,762	35,238	9,000	5,000	1,250	10,250	488	-
3	35,238	9,762	25,476	9,000	5,000	1,250	10,250	488	-
4	25,476	9,762	15,714	9,000	5,000	1,250	10,250	488	-
5	15,714	9,762	5,952	9,000	5,000	1,250	10,250	488	-
6	5,952	1,190	4,762	-	5,000	1,250	1,250	60	-
7	4,762	1,190	3,572	-	5,000	1,250	1,250	60	-
8	3,572	1,190	2,382	-	5,000	1,250	1,250	60	-
9	2,382	1,190	1,192	-	5,000	1,250	1,250	60	-
10	1,192	1,192	0	-	5,000	1,250	1,250	58	-
Total		45,000		36,000	45,000	11,250	47,250	2,250	-

Notes:

- For Year 2, Investor's additional contribution of \$45,000 treated as a separate investment. For Years 3-10, the prior year's ending net investment (column C).
- Calculated based on the separate investment made by Investor at the beginning of Year 2 multiplied by the ratio of the current year's income tax credits and other income tax benefits for the separate investment to the total income tax credits and other income tax benefits for the separate investment for Years 2-10 (column G). The amortization for Year 2: $\$45,000 \times (\$10,250 \div \$47,250) = \$9,762$.
- The beginning net investment for the year (column A) less the amortization of the investment for the year (column B).
- The incremental income tax credits allocated to Investor of \$9,000 per year for Years 2-5.
- Investor's share of the additional project costs related to the separate investment depreciated over the project's remaining useful life: $(\$900,000 \times 5\%) \div 9 = \$5,000$. For ease of illustration, Investor's share of the additional project tax losses is assumed to be entirely attributable to depreciation expense.
- The tax effects of Investor's share of project tax losses (column E): $\$5,000 \times 25\% = \$1,250$.
- The sum of the income tax credits for the year (column D) and the other income tax benefits from tax losses for the year (column F).
- The excess of the income tax credits and other income tax benefits for the year (column G) over the amortization of the investment for the year (column B).
- There are no additional non-income-tax-related cash returns expected as a result of the separate investment.

6. Proportional amortization method

Combination of separate and original investment schedules

The following table combines the amounts in the PAM schedule in [Example 6.4.10](#) and the amounts in the PAM schedule for the separate investment.

\$	A	B	C	D	E	F	G	H	I
Year	Beg. net investmt.	Amort. of investmt.	End. net investmt.	Inc. tax credits	Investor share of project tax losses	Other inc. tax ben. from tax losses	Inc. tax credits and oth. inc. tax ben.	Inc. tax credits and oth. inc. tax ben., net of amort.	Non-inc.-tax-related cash returns
1	255,000	54,643	200,357	50,000	25,000	6,250	56,250	1,607	500
2	245,357	64,405	180,952	59,000	30,000	7,500	66,500	2,095	500
3	180,952	64,405	116,547	59,000	30,000	7,500	66,500	2,095	500
4	116,547	64,405	52,142	59,000	30,000	7,500	66,500	2,095	500
5	52,142	15,833	36,309	9,000	30,000	7,500	16,500	667	500
6	36,309	7,261	29,048	-	30,000	7,500	7,500	239	500
7	29,048	7,261	21,787	-	30,000	7,500	7,500	239	500
8	21,787	7,261	14,526	-	30,000	7,500	7,500	239	500
9	14,526	7,261	7,265	-	30,000	7,500	7,500	239	500
10	7,265	7,265	0	-	30,000	7,500	7,500	235	500
Total		<u>300,000</u>		<u>236,000</u>	<u>295,000</u>	<u>73,750</u>	<u>309,750</u>	<u>9,750</u>	<u>5,000</u>

6.4.60 Changes in estimates under the PAM

Changes in estimates are accounted for prospectively. This may affect: [250-10-45-12, 45-17 – 45-20]

- the period of change when the change affects that period only; or
- the period of change and future periods when the change affects both.

Accordingly, changes in expectations related to income tax credits and other income tax benefits may require the investor to adjust the timing or rate of investment amortization for the current (and future) periods. Examples of these changes in expectations include:

- a change to true-up the estimated amounts used in the PAM schedule with the final amounts included in the Schedule K-1 provided by the tax equity investee; and
- a change in judgment about the total amount of benefits that are expected to be realized, such as:
 - the amount of income tax benefits that are not more likely than not to be realized (see [section 6.3.10](#)); and
 - the amount of carryforward benefits arising due to the investor's inability to realize income tax benefits in the current-year tax return (see [section 6.3.50](#)).

As discussed in [section 6.3.80](#), an investor reevaluates whether the PAM qualifying criteria are met when certain changes occur. When those criteria continue to be met, the investor considers whether any of the estimates included in the PAM schedule need to be changed.

Investors need to evaluate the reasons for adjustments to the PAM schedule or the carrying amount of the investment to assess whether such adjustments are a change in estimate or the correction of an error (see KPMG Handbook, [Accounting changes and error corrections](#)).

While changes in estimates are recognized prospectively, we believe that a change in estimate caused by a change in tax law may also be recognized through a cumulative effect adjustment (see [section 6.4.70](#)).

6.4.70 Effects of change in tax law on the PAM

As discussed in [section 6.3.80](#), we believe an investor should reevaluate the accounting model applied to its tax equity investments when there is a change in tax law that may affect whether:

- the PAM qualifying criteria are met; and/or
- the investment falls in the scope of Subtopic 323-740.

We believe the investor should first reevaluate its investments based on its revised expectation of the income tax benefits, and then assess those

investments for impairment by determining whether it is more likely than not that the investment is not realizable.

For investments that continue to meet the PAM qualifying criteria and fall in the scope of Subtopic 323-740, a revision to the PAM schedule is necessary.

We believe investors may elect to revise a PAM schedule using one of the following methods.

- **Cumulative effect.** The investor recasts the schedule as if it had known from the initial investment date that the tax law would be changed, and the change would occur on the actual enactment date.
- **Prospective.** The investor adjusts the future amortization of the carrying amount of the investment as of the enactment date based on the revised estimate of the remaining tax benefits.

We believe these approaches are acceptable because both maintain periodic investment amortization before and after the tax law change that is proportional to the tax benefits recognized.

[Section 6.4.60](#) discusses accounting for changes in estimates for reasons other than a change in tax law.

Cumulative effect

Under the cumulative effect method, an investor revises its PAM schedule through an adjustment to catch up its investment amortization to reflect the tax law change on the actual enactment date. The adjustment is necessary because the income tax credits and other income tax benefits after the enactment date likely will be a different proportion of the total benefits after considering the tax law change.

We believe an investor should recognize its cumulative effect adjustment due solely to the change in tax law with the other effects of the change in tax law – in income tax expense (benefit) from continuing operations.

Further, we believe an investor should assess the investment for impairment after it adjusts the investment balance for the revised PAM schedule (see [section 6.4.80](#)).

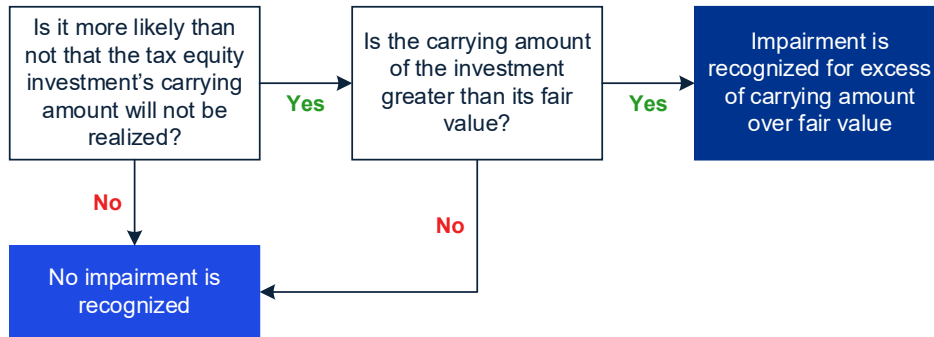
Prospective

When the prospective method is used to account for a tax law change, there could be a greater likelihood of the tax equity investment being impaired on the enactment date, depending on the nature of the tax law change. For example, there is a greater likelihood of impairment if the tax law change reduces the remaining income tax credits and other income tax benefits to be received by the tax equity investment and allocated to the investor. [Section 6.4.80](#) discusses evaluating a tax equity investment for impairment when the PAM is applied.

If the investment is not impaired and the investor adjusts its periodic amortization prospectively, it will recognize different margins after the tax law change because the remaining tax benefits will change with no change to the remaining amortization expense.

6.4.80 Impairment

The following decision tree depicts determining whether an investment accounted for using the PAM is impaired.



A tax equity investment accounted for using the PAM is tested for impairment when it is more likely than not that its carrying amount will not be realized. [323-740-35-6]

An impairment test compares the carrying amount of the investment with its fair value. An impairment loss is recognized for the excess of the investment's carrying amount over this fair value. Once recognized, an impairment loss cannot be reversed. [323-740-35-6]

Investors generally evaluate the realizability of tax equity investments accounted for using the PAM based on estimates of the availability of the remaining total income tax benefits and the ability to realize those benefits (see [sections 6.3.10](#) and [6.3.50](#) for discussion of the realizability of certain tax benefits). Cash flows from operations or the anticipated proceeds from the sale or disposition of the investment may also be considered. However, if the expected income tax benefits are not adequate to realize the investment's carrying amount, the PAM qualifying criteria are unlikely to be met on an ongoing basis.

For example, if cash flows from operations are needed to support the realizability of the tax equity investment, the investor's projected yield would no longer be positive based solely on income tax credits and other income tax benefits. Because this would mean one of the PAM qualifying criteria (the projected yield criterion) is no longer met, the investor cannot continue to apply the PAM (see [section 6.3.90](#)).

Presentation of impairment triggered by a change in tax law

As discussed in [sections 6.3.80](#) and [6.4.70](#), a change in tax law may result in the investor assessing a tax equity investment for impairment by determining whether it is more likely than not that the investment is not realizable. While an impairment not related to a change in tax law is presented as a pretax loss, we believe that an investor should recognize an impairment due solely to a change in tax law with the other effects of the change in tax law – i.e. in income tax expense (benefit) from continuing operations.

6.4.90 Sale or disposition of the investment

If an investor sells or disposes of its tax equity investment, any gain or loss is recognized in pretax earnings upon sale or disposition. [323-740-35-5]

6.5 Disclosures when the PAM has been elected

A disclosure objective and certain disclosure requirements apply to all tax equity investments within tax credit programs for which the PAM is elected (regardless of whether the investment meets the PAM qualifying criteria). [323-740-50-1, 50-1A]

The disclosure objective is to provide information on an interim and annual basis that enables financial statement users to understand the following about tax equity investments that generate tax credits from tax credit programs for which the PAM is elected: [270-10-50-7, 323-740-50-1]

- the nature of those investments; and
- the effect of the recognition and measurement of those 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, there are required disclosures on an interim and annual basis, as well as additional recommended disclosures. [270-10-50-7, 323-740-50-1A, 50-2]

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 (see below).
- The balance of the tax equity investments and the line item in which they are recognized on 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 (see below).
- Significant modifications or events that resulted in a change in the nature of the tax equity investment or a change in the relationship with the underlying project.

Additional disclosures to consider in satisfying the disclosure objectives

- For tax equity investments accounted for using the equity method (see [section 6.3.100](#)), the amount of investment income or loss included in pretax income.

Additional disclosures to consider in satisfying the disclosure objectives

- Information about commitments or contingent commitments, including the amount of delayed equity contributions (see [sections 6.3.60](#) and [6.4.50](#)), and the year or years in which contingent commitments are expected to be paid.
- The nature and amount of impairment losses recognized during the year (see [section 6.4.80](#)), including whether they resulted from the forfeiture or ineligibility of income tax credits.

Interim income statement effects

For interim reporting purposes, the tax effects of the PAM are generally included in the estimated annual effective tax rate instead of being treated as a discrete item. As such, to determine the amount of income tax credits, other income tax benefits and investment amortization recognized during an interim period for disclosure purposes, the investor will need to consider the percentage of its full-year ordinary income recognized in the interim period. For example, if in [Example 6.4.10](#), Investor recognized 28% of its full-year ordinary income in the first quarter of Year 1, it would disclose that it recognized the following in its first quarter:

- \$14,000 of income tax credits (\$50,000 for Year 1 × 28%);
- \$1,750 of other income tax benefits (\$6,250 for Year 1 × 28%); and
- \$15,300 of investment amortization (\$54,643 for Year 1 × 28%).

Statement of cash flow line items that include income tax credits, other income tax benefits and non-income-tax-related activity

Disclosing the line items in the income statement that include the amounts of income tax credits, other income tax benefits and non-income-tax-related activity recognized during the year related to a tax equity investment may be relatively straightforward. However, the same might not be true for disclosing the line items in the statement of cash flows that include those amounts, particularly when the investor uses the indirect method to present cash flows from operating activities.

In this situation and as illustrated in [Example 6.5.10](#), the investor must carefully consider the line items in the statement of cash flows where the income tax credits, other income tax benefits and non-income-tax-related activity are ultimately presented. We believe an investor generally presents cash flows related to income tax credits, other income tax benefits and non-income-tax-related activity as part of cash from (used for) operating activities. We also believe an investor using the indirect method should disclose the total income tax benefit that results in a reduction of current tax expense as a decrease in the applicable line item (e.g. 'Increase (decrease) in income taxes payable') in the reconciliation of net income (loss) to cash from (used for) operating activities.



Example 6.5.10

Disclosure of income tax credits, other income tax benefits and non-income-tax-related activity and related financial statement line items

The same facts are used in this example as are used in [Example 6.4.10](#). Also, assume the following additional facts:

- Investor presents the cash flows related to the income tax credits and other income tax benefits allocated to it by TEI in operating activities;
- Investor uses the indirect method to present cash flows from operating activities; and
- Investor used the income tax credits and other income tax benefits to reduce current tax expense (i.e. they did not result in carryforwards).

Investor makes the following disclosure in Year 1 about the amount of income tax credits, other income tax benefits and non-income-tax-related activity recognized related to its investment in TEI and the line items in the income statement and statement of cash flows in which those amounts have been presented.

With respect to our tax equity investment in TEI, we recognized income tax credits and other income tax benefits in Year 1 of \$50,000 and \$6,250, respectively. The total income tax benefits of \$56,250 are partially offset in the 'Income tax expense (benefit)' line item in the income statement by \$54,643 of investment amortization recognized in Year 1, for a net income tax benefit of \$1,607. The cash flows related to the total income tax benefits are presented in the following line items in the statement of cash flows:

- \$1,607 in the 'Net income (loss)' line item in operating activities;
- \$54,643 in the 'Investment amortization included in income tax expense (benefit)' line item, which is an adjustment to reconcile net income (loss) to cash from (used for) operating activities; and
- \$56,250 decrease in the 'Increase (decrease) in income taxes payable' line item, which is also an adjustment to reconcile net income (loss) to cash from (used for) operating activities.

In addition, we recognized non-income-tax-related activity in Year 1 of \$500 in the 'Other income (expense)' line item in the income statement. The cash flows related to the non-income-tax-related activity are presented in the 'Net income (loss)' line item in the operating activities section of the statement of cash flows.

6.6 Effective date and transition

As discussed in [section 6.1](#), this chapter covers Subtopic 323-740 as amended by ASU 2023-02. For the guidance in effect prior to the effective date of ASU

2023-02, see Appendix B of KPMG Handbook, [Accounting for income taxes](#). This section covers the effective date and transition for ASU 2023-02.

6.6.10 Effective date

The effective dates for ASU 2023-02 are as follows. [323-740-65-2(a), 65-2(b)]

	Public business entities	All other entities
Annual and interim periods in fiscal years beginning after...	December 15, 2023	December 15, 2024

Entities may early adopt the ASU in any interim period, with adjustments to opening balances at the beginning of the fiscal year that includes the interim period. [323-740-65-2(c)]

6.6.20 Transition methods

The transition methods differ depending on whether ASU 2023-02's PAM and PAM-related clarifications or other changes (see [section 6.1](#)) are being adopted.

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. [323-740-65-2(d)]

Transition provision	Modified retrospective	Retrospective
Apply the PAM to all qualifying tax equity investments expected to generate income tax credits or other income tax benefits as of...	the beginning of the fiscal year of adoption (i.e. application date).	the beginning of the earliest period presented (i.e. the application date).
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...	<ul style="list-style-type: none"> actual income tax benefits allocated as of the application date; and estimated income tax benefits expected to be allocated after the application date. 	actual equity contributions made and expected remaining equity contributions as of the application date.
Record a cumulative effect adjustment in	the difference between the carrying amounts of the investment as of the application date based on:	

6. Proportional amortization method

Transition provision	Modified retrospective	Retrospective
retained earnings calculated as...	<ul style="list-style-type: none"> the previous accounting; and the new accounting, as if it had been applied since the investment date. 	

The transition method elected must be consistently applied to all affected investments. [323-740-65-2(d)]

One of the PAM-related clarifications requires use of the flow-through method when the PAM is used to account for a tax equity investment. If an investor used the PAM to account for a LIHTC investment, but the deferral method to account for the related income tax credits, the cumulative effect adjustment should include the effects of transitioning from the deferral method to the flow-through method.

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. [323-740-65-2(e)]

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 a 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. [323-740-65-2(e), ASU 2023-02.BC29]

- 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 a 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.



Example 6.6.10

Prospective application of removal of the equity method impairment guidance

Investor has a tax equity investment to which it has applied the equity method impairment guidance removed by ASU 2023-02. Investor elects the prospective application option to account for the ASU's removal of this guidance and begins applying Topic 323 on the adoption date. The investment's carrying amount is \$200,000.

Investor concludes it is required to perform an impairment evaluation under Topic 323 on the adoption date. In doing so, it estimates the fair value of the investment as \$150,000 and concludes the investment is other-than-temporarily impaired. As a result, Investor recognizes a \$50,000 impairment loss in pretax income and a reduction to the investment's carrying amount on the date of adoption.

If Investor had concluded it was not required to perform an impairment evaluation under Topic 323 on the adoption date, no adjustment would be recognized under the prospective application option.



Example 6.6.20

Prospective application of removal of the cost method guidance

Investor has a tax equity investment to which it has applied the cost method guidance removed by ASU 2023-02. Investor elects the prospective application option to account for the ASU's removal of this guidance and begins applying Topic 321 on the adoption date. The investment's carrying amount is \$300,000.

Investor concludes the investment has a readily determinable fair value under Topic 321, which is \$330,000 on the adoption date. Accordingly, Investor recognizes an adjustment to the investment's carrying amount and pretax income of \$30,000.

6.6.30 Transition disclosures

The disclosures required upon transition to ASU 2023-02 are consistent with those otherwise required for accounting changes under Topic 250 (accounting changes and error corrections) and include: [\[323-740-65-2\(g\)\]](#)

- the nature and reason for the change (i.e. adoption of ASU 2023-02);
- the transition method(s) applied and a description of any retrospectively adjusted prior-period information;
- for the prior periods retrospectively adjusted, the change's effect on income from continuing operations, net income and any per-share amounts;
- the change's cumulative effect on retained earnings; and
- a qualitative description of the financial statement line items affected by the change.

If an entity issues interim financial statements, the preceding disclosures are provided in both the interim and annual financial statements for the period of change. For example, a public business entity with a calendar year-end that adopts the ASU on the applicable effective date provides the preceding disclosures in the interim financial statements for its first quarter of 2024 and its annual financial statements for 2024.

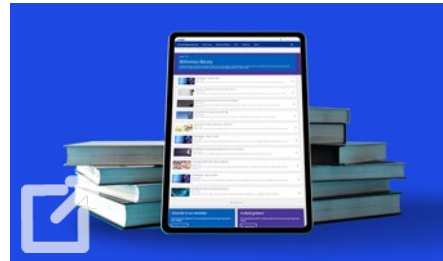
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