KPMG

Tax credits

Handbook

US GAAP

October 2025

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Contents

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

Have you ever tried to compare the effects of tax credits on the effective tax rate across entities? You may find that tax credits can follow a direct or winding path to the income tax line – or, in some cases, bypass it altogether.

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;
- how the tax credit can be monetized; and
- what the tax credit is designed to incentivize.

Adding to this diversity are the policy choices in US GAAP – of which there are many – and practices that have developed over time as entities try to apply the limited guidance available.

The Inflation Reduction Act (IRA) ushered in a new era of credit monetization – introducing elective payment (direct pay) and third-party transfer provisions that expanded access to tax credits well beyond the traditional tax-paying population. Now, with the enactment of the *One Big Beautiful Bill* Act (OBBB), the landscape is evolving again. The bill accelerates phase-outs, repeals certain credits altogether, and imposes new eligibility restrictions – while preserving many of the mechanisms that have transformed how tax credits are used and reported.

This Handbook is designed to help you navigate the complexity inherent in a constantly evolving tax credit environment shaped by ongoing legislative and accounting developments. We hope you find the explanations 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 for the different types of tax credits and policy choices available.

Organization of the text

Entities typically obtain benefits from tax credits by (1) generating them through their own operations (e.g. participation in certain activities or ownership of qualifying property) or (2) investing in pass-through entities that generate them in their operations. When an entity generates tax credits through its own operations, it considers whether the tax credits are refundable and/or transferable. When an entity invests in pass-through entities that generate tax credits, it considers those same things plus 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 scenarios 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 (equity method and joint ventures) and is discussed in depth in KPMG Handbook, Equity method of accounting.

This Handbook makes reference to the FASB 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 (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 Standard 20, Accounting for Government Grants and Disclosure of Government Assistance, under IFRS® Accounting Standards

October 2025 edition

The tax equity investments portion of this Handbook (now chapters 6 to 8) have been substantially reorganized. Chapter 6 has been included to explain how

these investments work and introduce the accounting considerations that accompany them. Chapters 7 and 8 (formerly chapters 6 and 7, respectively) provide details on how to account for these investments.

This edition includes new and updated interpretations and examples based on our experience with companies accounting for tax credits. New Questions and Examples are identified with ** and items that have been significantly updated or revised are identified with #. The Index of changes identifies all significant changes.

Accounting Standards Update (ASU)

In March 2023, the FASB issued ASU 2023-02, which expands the population of investments for which an investor may elect to apply the proportional amortization method (PAM) (see chapter 8). 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 that generate income tax credits and other income tax benefits from 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.

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
IRC	Internal Revenue Code
IRR	Internal rate of return
IRS	Internal Revenue Service
ITC	Investment tax credit
LIHTC	Low-income housing tax credit
NCI	Noncontrolling interest

NIC	National insurance contributions
OBBB	Pub. L. No. 119-21, 139 Stat. 72 (2025) (commonly referred to as the *One Big Beautiful Bill* Act)
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

Item significantly updated in this edition: #

Overview#

Entities can benefit from tax credits (1) through participation in certain activities or ownership of qualifying property or (2) via investments in pass-through entities. Such credits may include investment tax credits (ITCs), production tax credits (PTCs), research and experimentation credits, work opportunity credits, and foreign tax credits.

Historically, these tax credits have generally been nonrefundable and nontransferable, meaning the only way a taxpayer could monetize such credits was by using them to lower its income tax bill. Therefore, if a taxpayer did not owe taxes in the first place (e.g. because it is generating losses) there were limited options available for realizing the benefits of nonrefundable and nontransferable tax credits.

However, that changed for many credits with the enactment of the Inflation Reduction Act of 2022 (IRA) and CHIPS and Science Act of 2022 (CHIPS), which introduced additional mechanisms for monetizing certain tax credits. These mechanisms include elections for:

- 'direct pay', which allows certain entities to receive a payment from the government equal to the value of the tax credit that is in excess of the entity's tax liability (credits for which this election is available are called refundable credits); and
- third-party transfer, which allows entities to sell the tax credit for cash (credits for which this election is available are called transferable credits).

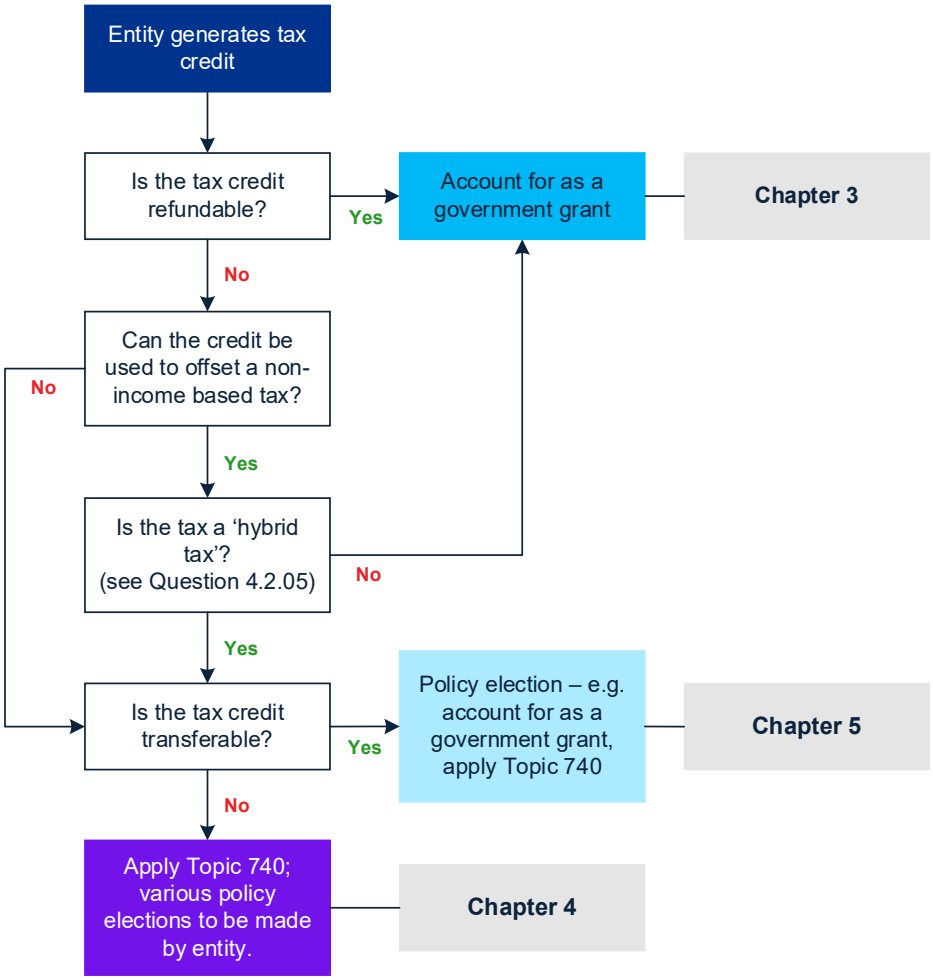
Because of these mechanisms, entities no longer need to have an income tax liability to benefit from these types of credits.

On July 4, 2025, President Trump signed into law H.R. 1 – the budget reconciliation bill known as the 'One Big Beautiful Bill' (OBBB). The bill marks the next phase in the evolution of federal tax credits, significantly modifying many of the credits introduced under the IRA. It includes accelerated phase-outs, repeals of certain credits, and limitations tied to foreign ownership and supply chain considerations, while preserving the monetization and bonus provisions for certain credits.

These direct pay and transferability features introduce added layers of complexity to accounting for income tax credits. The appropriate accounting depends on (1) who generates the tax credit (i.e. the entity or one of its pass-through investees), (2) how it can be monetized (i.e. whether it is transferable or refundable), and (3) what it is designed to incentivize.

Tax credits generated from an entity's own operations

The following decision tree outlines the key considerations in accounting for tax credits generated from an entity's own operations.



The following table summarizes the accounting implications of different monetization mechanisms for tax credits.

Monetization mechanism	Accounting
Refundable	We believe refundable credits, whether transferable or not, should be accounted for as government grants. This is the case regardless of whether the entity intends to choose the direct pay election or to use the credits to offset its income tax liability. However, US GAAP currently provides no specific guidance on how business entities account for government grants and there is diversity in practice. In our experience, many companies have an existing policy to analogize to IAS 20, Accounting for Government

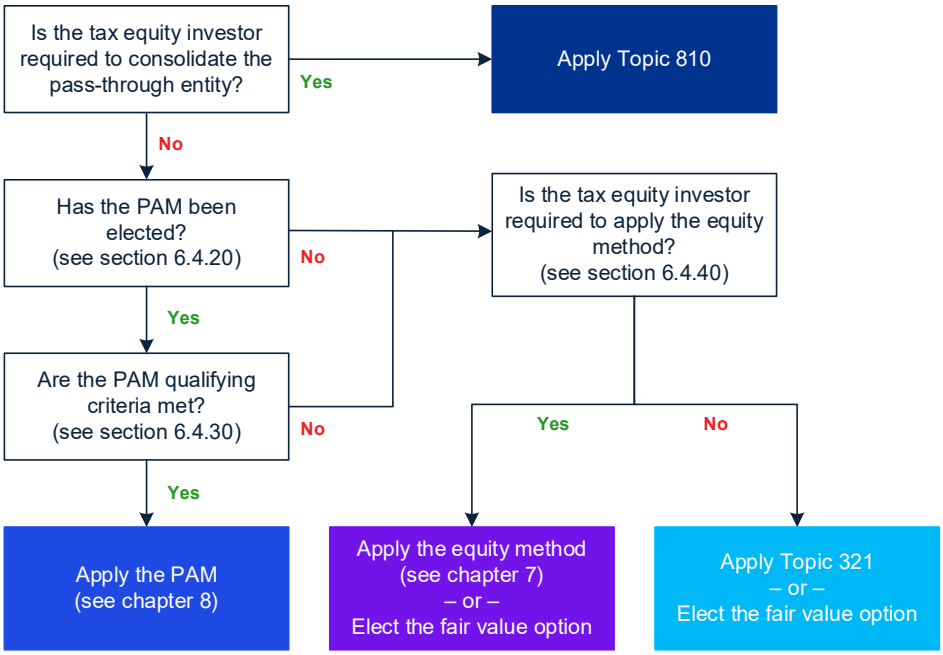
Monetization mechanism	Accounting
	Grants and Disclosure of Government Assistance, under IFRS® Accounting Standards. Other acceptable approaches include analogizing to Subtopic 958-605 (not-for-profit entities – revenue recognition) or Subtopic 450-30 (gain contingencies). For further discussion about accounting for refundable credits, see chapter 3.
Nonrefundable, nontransferable	Nonrefundable, nontransferable tax credits are in the scope of Topic 740 because they only can be monetized if the entity has a sufficient amount of income tax liability to utilize the credit. Under Topic 740, the accounting depends on whether the credit is an ITC (i.e. what the credit is designed to incentivize). • ITCs: Topic 740 provides an accounting policy choice to use the deferral method or the flow-through method. Under the deferral method, which is the preferred method, an entity recognizes the benefit of the ITC over the productive life of the underlying asset(s) that gave rise to the ITC. Under the flow-through method, an entity immediately recognizes the benefit of the ITC as a reduction of its income tax expense in the period when it arises. • Other tax credits: An entity immediately recognizes the benefit of the credit as a reduction of its income tax expense in the period when it arises, consistent with the flow-through method for ITCs. For further discussion about accounting for nonrefundable, nontransferable credits, see chapter 4.
Nonrefundable, transferable	We believe entities can make an accounting policy election to account for nonrefundable, transferable credits in one of the following ways: • apply Topic 740 (income taxes), consistent with the accounting for nonrefundable, nontransferable credits; or • account for as a government grant, consistent with the accounting for refundable credits. There are additional accounting considerations if the entity sells the credit, and for the entity that purchases the credit. For further discussion about accounting for nonrefundable, transferable credits, see chapter 5.

Investments in pass-through entities that generate tax credits

Instead of generating tax credits through its own operations, an entity can benefit from tax credits (and other tax benefits) by investing in a pass-through entity that generates these items (referred to as a tax equity investment). There are numerous accounting models that may apply to a tax equity investment, but

in practice many entities use the equity method or the proportional amortization method (PAM).

The following decision tree outlines the key considerations in accounting for investments in pass-through entities that generate tax credits.



Equity method

The equity method under US GAAP (Topic 323) does not address an investor's accounting for the tax benefits received in the form of tax credits from an equity method investee. We believe the investor's accounting for such credits ultimately depends on (1) how they can be monetized, (2) what the credit is designed to incentivize and (3) the investor's accounting policies assuming that it had generated them through its operations.

Monetization mechanism	Investor's accounting
Refundable	We generally believe an investor accounts for refundable tax credits generated by a pass-through entity as part of its overall equity method pickup consistent with all other items of income or loss reported in the pass-through entity's financial statements. However, other approaches may be acceptable. See section 7.3 for further discussion.
Nonrefundable, nontransferable	We believe an investor accounts for nonrefundable, nontransferable tax credits generated by a pass-through entity as a separate unit of account under Topic 740 as if the investor generated the credit through its operations. The accounting for the tax credits under Topic 740 depends on whether they are ITCs or another type of credit.

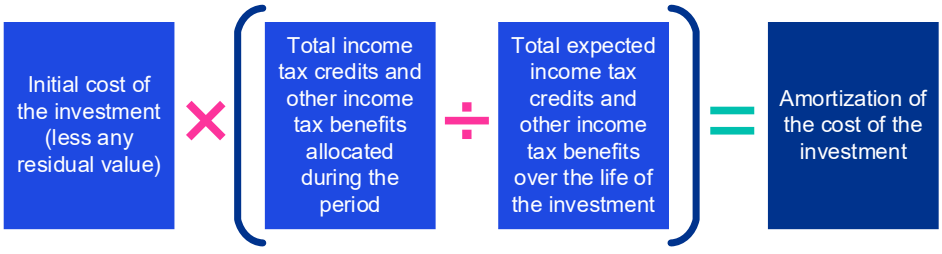
Monetization mechanism	Investor's accounting
	The investor then applies the equity method to recognize its share of the *other* items of income or loss reported in the pass-through entity's financial statements. See section 7.4 for further discussion.
Nonrefundable, transferable	We believe an investor accounts for nonrefundable, transferable credits based on policy elections it makes. If its policy is to account for such credits as government grants, then we believe the investor generally accounts for the credits in a manner consistent with the discussion above for refundable credits. That is, it accounts for the transferable tax credits as part of its overall equity method pickup consistent with all other items of income or loss reported in the pass-through entity's financial statements. However, other approaches may be acceptable. If its policy is to account for such credits as income taxes under Topic 740, then we believe the investor accounts for the credits in a manner consistent with the discussion above for nonrefundable, nontransferable credits. That is, it accounts for the transferable tax credit as a separate unit of account as if it generated the credit through its operations. To the extent that its accounting policy for transferable credits is different from the pass-through entity's, the investor may need to recast the pass-through entity's financial statements when calculating its equity method income or loss. See section 7.5 for further discussion.

For further discussion about accounting for tax credits generated by a pass-through entity under the equity method, see chapter 7.

PAM

An investor may elect to account for its investment using the PAM if certain criteria are met.

Under the PAM, the cost of the 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.



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 from the tax equity structure during the period to the total income tax benefits expected to be received over the life of the investment.

Disclosures are required for investments that generate income tax credits and other income tax benefits from tax credit programs for which the PAM is elected, including those where the PAM is not applied.

For further discussion about accounting for tax credits generated by a pass-through entity under the PAM, see chapter 8. For discussion of whether an investment qualifies for the PAM, see section 6.4.

2. Overview of US federal tax credits

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

2.1 Overview#

This chapter provides a high-level overview of various US federal tax credits. Entities should consider the latest relevant sections of the IRC, Treasury regulations and related rules.

The US federal tax system offers a range of tax credits to corporate taxpayers, providing incentives for various activities and investments. These tax credits are designed to promote economic growth, job creation, and specific industries or initiatives.

Some of the key federal tax credits available to corporate taxpayers include research and experimentation tax credits, various ITCs, LIHTCs, PTCs, and work opportunity tax credits. Each of these credits offers unique benefits and eligibility criteria, encouraging businesses to engage in research and innovation, invest in capital assets, support affordable housing, promote renewable energy, and hire individuals from targeted groups. These tax credits can significantly reduce a corporation's tax liability and provide opportunities for businesses to contribute to societal and economic development while maximizing their financial resources.

Foreign tax credits (FTCs) are another important aspect of the US federal tax system, allowing corporate taxpayers to reduce their US tax liability when income taxes have been paid to foreign governments. The purpose of FTCs is to prevent double taxation on income earned by US corporations abroad.

Entities typically generate tax credits through their own operations (e.g. participation in certain activities or ownership of qualifying property). However, entities can also obtain the benefits of tax credits by investing in pass-through entities that generate such credits.

Historically, US federal tax credits have generally been both nonrefundable and nontransferable. This means that the only way a taxpayer could monetize such credits was by using them to lower its income tax liability. Therefore, if a taxpayer did not owe taxes in the first place (e.g. because it was generating losses) there were limited options available for realizing the benefits of tax credits.

That dynamic began to shift with the passage of the IRA in 2022, which introduced two new mechanisms for monetizing certain credits:

- direct pay, which allows certain entities to receive a payment from the government equal to the value of the tax credit that is in excess of the entity’s tax liability (referred to as refundable credits); and
- third-party transfer, which allows entities to sell the tax credit for cash (referred to as transferable credits).

These changes transformed the landscape for tax credit utilization, enabling a much broader range of taxpayers—including tax-exempt organizations and companies without current taxable income—to participate in federal credit programs.

The IRA also introduced the concept of bonus rates and adders, which increase the amount of certain credits when specific project-level criteria are met, such as domestic content requirements or siting in an energy community.

The bill marks the next phase in the evolution of federal tax credits by significantly modifying many of the credits introduced under the IRA. Specifically, the bill accelerated phase-outs of some credits, repealed others, and introduced limitations tied to foreign ownership and supply chain considerations. The bill did not repeal the direct pay or third party transfer features of the IRA credits outright; however, it did introduce new restrictions related to specified foreign entities (as further described in section 2.5).

The remainder of this chapter describes how the direct pay and third party transfer mechanisms work under the current federal tax law, assuming foreign entity restrictions do not apply, and outlines the criteria that must be met for a tax credit to be eligible for bonus rates or adders.

Section 2.5 summarizes the key features of the tax credits originally introduced under the IRA and CHIPS Acts and explains how each has been impacted by the bill.

2.2 Direct pay feature

Direct pay (formally titled as 'elective payment') is an option that allows taxpayers to treat the amount of a tax credit as a payment of US federal income tax. If the amount of the 'payment' exceeds the taxpayer's income tax liability, the taxpayer receives a refund equal to the difference (which could be the full amount of the credit if no income tax liability exists). The availability of the direct pay election varies by credit and is only effective for taxable years beginning after December 31, 2022.

2.2.10 Federal tax credits eligible for direct pay

The majority of federal tax credits that are eligible for direct pay are only available to tax-exempt entities, state and local governments, and Indian tribal governments (referred to as applicable entities). However, the direct pay election is available to other taxpayers that are not applicable entities (referred to as electing 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 PTC.

Generally, direct pay elections have to be made with respect to a specific qualified energy property or facility in the year that the property, facility or equipment is placed into service. Once made, the direct pay election applies to the taxable year in which the election is made and each of the four subsequent

taxable years that end before January 1, 2033. This essentially means that direct pay applies for the first five years after its election.

Electing taxpayers may make the direct pay election for section 45X credits in any taxable year because this PTC does not require that a new facility be constructed to be eligible.

2.2.20 How to elect direct pay

To make the direct pay election, an entity must first complete a pre-filing registration with the IRS that will include information about the entity, the credits to be earned, each eligible project/property that will generate credits, and other required information. The IRS will then provide the entity with a registration number for each applicable credit property, which the entity must provide on its federal income tax return.

Once the entity has satisfied all of the eligibility requirements, it must complete IRS Form 3800, General Business Credit, and attach it, along with other source forms and attachments, to its federal income tax return to make the direct pay claim. The direct pay election can only be made on an original and timely filed tax return, including the registration number received from the pre-filing registration process, and cannot be made on an amended return or by filing an administrative adjustment request under IRC section 6227.

2.2.30 Election at the pass-through entity level

For Partnerships and S Corporations that generate eligible tax credits, the direct pay election can only be made at the partnership or corporation level. The resulting payment will be treated as tax-exempt income and allocated to the partners or shareholders based on their share of the applicable credit. For the purpose of the direct pay election, a partnership is not a tax-exempt or government entity, even if all of the partners are tax-exempt or government entities. Therefore, a Partnership can only make the direct pay election for section 48D, 45Q, 45V, and 45X credits that are available to all taxpayers.

2.2.40 Revocation of direct pay election#

While direct pay elections are generally irrevocable, an electing taxpayer is allowed a one-time revocation per eligible property. The revocation applies to the taxable year in which the revocation is made and each subsequent taxable year. Once revoked, an election cannot be reinstated. It is important to note that the election cannot be made or revoked on an amended return.

2.3 Third-party transfer feature

The third-party transfer feature allows an electing taxpayer (a seller) who generates tax credits to transfer all or a portion of a tax credit to an unrelated buyer in exchange for cash. The availability of the third-party transfer feature varies by credit.

Each credit can only be transferred once and it must be sold for cash consideration. However, a seller may enter into a contract to sell eligible credits in the future as long as it receives the cash from the buyer during the period that begins on the first day of its taxable year in which the credit is earned and ends on the date that the transfer election statement (see below) is due. Further, while a seller can sell a portion of a tax credit, the proportionate share sold must include any bonus amounts (i.e. the base credit and the bonus credits cannot be separated). The cash received from the sale of a credit is excluded from the seller's taxable income.

The buyer can only use the credit to offset its income taxes (i.e. the buyer cannot transfer it to another party or make a direct pay election, also referred to as chaining). A buyer may take into account a credit that it has purchased, or intends to purchase, when calculating its estimated tax payments. However, the buyer is liable for any underpayment penalties in such situations.

2.3.10 Federal tax credits eligible for third-party transfer

The third-party transfer feature is available for the following credits:

- Section 48 Energy Credit
- Section 48E Clean Electricity Investment Credit
- Section 45 Renewable Electricity Production Credit
- Section 45Y Clean Electricity Production Credit
- Section 45U Zero-emission Nuclear Power Production Credit
- Section 45X Advanced Manufacturing Production Credit
- Section 45V Clean Hydrogen Production Credit
- Section 45Z Clean Fuel Production Credit
- Section 45Q Carbon Oxide Sequestration Credit
- Section 30C Credit for Alternative Fuel Vehicle Refueling/Recharging Property
- Section 48C Qualified Advanced Energy Project Credit

2.3.20 How to transfer a credit

The seller must follow the steps below to transfer an eligible credit:

- Make an electronic pre-filing registration with the IRS that includes information about the taxpayer, the intended eligible credits and the eligible credit project. Once the pre-filing registration is complete, the IRS will issue a registration number for each eligible credit property.

- Complete all requirements necessary to earn the eligible tax credit for that tax year.
- Arrange to transfer the credit to an unrelated party in exchange for only cash and provide the buyer with the registration number and all other information necessary to claim the transferred credit.
- Complete a transfer election statement. The transfer election statement includes the name, address, and taxpayer identification number for both parties, a description of the type and amount of the eligible tax credit transferred, the timing and amount of cash paid for the transferred credit, and the registration number related to the eligible credit property.
- File the federal income tax return for the tax year in which the credit was earned. The tax return must include (1) the transfer election statement, (2) the registration number for the relevant credit property, and (3) other information as required by the tax rules.

2.3.30 How to claim a transferred credit

To claim a transferred credit, a buyer must complete the following steps:

- Obtain the registration number of the eligible credit property from the seller, along with all other necessary information
- Obtain the transfer election statement from the seller (or complete the statement with the seller)
- File a tax return for the taxable year in which the eligible credit is claimed. The tax return must include (1) the transfer election statement, (2) the registration number for the relevant credit property, and (3) other information as required by the tax rules.

2.3.40 Credits subject to recapture#

Transfers of Sections 48, 48E, 48C, and 45Q credits are subject to recapture. If a recapture event occurs, the seller is required to notify the buyer. However, the buyer is generally financially responsible for the recaptured amounts. Additionally, the burden of documentation falls to the buyer of the credit. As a result, many of these tax credit transfer arrangements include provisions for credit insurance and seller indemnification to address the various regulatory compliance risks related to these tax credits. In addition, the OBBB added a new level of complexity in terms of Foreign Entity of Concern restrictions that should be considered. Section 2.5 provides additional consideration related to the changes introduced by the OBBB.

2.4 Bonus rates and adders

Under the IRA, certain tax credits are eligible for bonus amounts whereby the amount of the credit that can be claimed is increased by a multiple of five if the taxpayer or eligible project satisfies the 'prevailing wage and registered apprenticeship' requirements. Such credits therefore contain a 'base rate' and a 'bonus rate'.

Prevailing wage and apprenticeship requirements

Ensuring that laborers and mechanics who support the project are paid prevailing wages[1] and that qualified apprentices perform a specified portion of labor increases the credit rate fivefold.

The **definition of 'employed'** for purposes of the prevailing wage requirements is different and broader than the definition used elsewhere in the IRC. A laborer or mechanic would be considered employed if the individual performs the duties of a laborer or a mechanic regardless of whether the individual would be characterized as an employee or an independent contractor for other federal tax purposes.

If an entity **fails to satisfy the prevailing wage requirements**, it can cure the failure by compensating each worker the difference between wages paid and the prevailing wage, plus interest, in addition to paying a $5,000 penalty to the Treasury for each worker paid below the prevailing wage during the tax year. If the failure to pay prevailing wages is due to intentional disregard, the entity must pay three times the pay differential to laborers and pay a $10,000 penalty per worker within 180 days of the date of determination of noncompliance.

Entities must also ensure that at least a specified percentage of total labor hours are performed by **qualified apprentices**. The applicable percentage for this requirement is 10% for projects that began construction in 2022, 12.5% for projects that began in 2023, and 15% thereafter. If the entity fails to satisfy the qualified apprenticeship requirements, it may cure the failure by paying a $50 penalty for each labor hour for which the requirement is not satisfied. If the IRS determines the failure is due to intentional disregard, the penalty increases to $500 per hour. However, there is an exemption process in the event there is a lack of available qualified apprentices.

The IRA also contains 'adders', which can further increase the base and bonus rates if additional requirements are met.

Domestic content requirements

Taxpayers can receive an additional 10% increase if a facility meets the domestic content requirements. Domestic content is generally defined as steel, iron or manufactured products that are manufactured or produced in the US. For purposes of these requirements, a manufactured product is deemed to have been manufactured in the US if an applicable percentage of the total cost of the components of such product is attributable to components that are mined, produced or manufactured in the US. The applicable percentage is 40%, except for offshore wind, which is 20%. For most projects that begin construction after 2026 the applicable percentage will increase to

[1] As determined by the Secretary of Labor in accordance with subchapter IV of chapter 31 of title 40 of the United States Code, also known as the Davis-Bacon Act.

Domestic content requirements
55%, and for offshore wind facilities that begin construction after 2027 the applicable percentage will increase to 55%.

Energy community requirements
Taxpayers can receive an additional 10% increase if the project is placed in service in an 'energy community'. Energy communities include (1) a brownfield site[2], (2) an area that has or had a certain amount of employment or tax revenues related to the extraction, processing, transport, or storage of coal, oil, or natural gas and has an above-average unemployment rate, or (3) a census tract or adjacent area in which a coal mine has closed after 1999 or a coal-fired electric generating unit has been retired after 2009. Qualifying projects located in an energy community are eligible for increased or bonus tax credits.

Low-income communities bonus requirements
Taxpayers can receive further increases of 10% to 20% for qualified solar and wind energy facilities with a maximum net output of less than five megawatts. A 10% increase is available for qualified facilities that are installed in low-income communities or on Indian land. A 20% increase is available for qualified facilities that are part of a qualified low-income residential building or a qualified low-income economic benefit project. Entities are required to pre-apply and receive a capacity allocation in order to receive this bonus.

Qualifying for bonus rates and adders

The available bonus rates and adders can increase a credit substantially. For example, a company may invest in an energy storage project that is eligible for an ITC under the IRA at a base rate of 6%. If the company meets the prevailing wage and apprenticeship, domestic content and energy community requirements, that 6% ITC becomes a 50% ITC.

These requirements may seem straightforward, but there are a number of intricacies that arise when putting them into practice. For example, domestic content requirements can be quite granular, particularly when zooming in on the component and subcomponent level of manufactured products. Prevailing wage and apprenticeship requirements entail reading the fine print as well; they are applicable not only during the construction of the project, but possibly also for several years after it begins operations. And finally, the map of energy communities is not cut and dry. Projects may span multiple tracts of land, and the energy community definition may change from year to year. Therefore, it is critical that taxpayers not assume a project will automatically meet the criteria for an increase or bonus rate.

[2] As defined in certain subparagraphs of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA)

2.5 One Big Beautiful Bill**

The bill makes significant changes to many of the energy tax credits introduced by the IRA, including repealing specific credits and introducing new phase-outs for others. In addition, the bill introduces special rules for prohibited foreign entities (defined as a 'specified foreign entity[3]' or a 'foreign-influenced entity') on a tax-credit-by-tax-credit basis. Generally, these rules disallow:

- tax credits if the taxpayer is a specified foreign entity or foreign influenced entity; and
- transfers of the tax credits to specified foreign entities for tax years beginning after July 4, 2025.

Further, the bill disallows certain credits for which a facility receives any 'material assistance' from a prohibited foreign entity.

The following table summarizes the key features of the tax credits introduced under the IRA and CHIPS and how they were impacted by the bill.

[3] Specified foreign entities include governments and certain individuals and entities of a covered national as defined under 10 USCA 4872(f)(2) – generally China, Russia, North Korea and Iran.

Credit		Key features under IRA and CHIPs			Effects of OBBB			
Section ref.	Credit name or type	Bonus rates and/or adders?	Transferable?	Direct pay?	Repealed?	Changes to or acceleration of phase outs?	New 'foreign prohibited entity' rules?	Changes to eligibility criteria?
45	Renewable energy production tax credit (PTC)	Yes	Yes	No	No	No	No	No
48	Energy property ITC	Yes	Yes	No	No	Yes	No	No
45Q	Carbon capture and sequestration	Yes	Yes	Yes (5-years)	No	No	Yes	No
30C	Alternative fuel refueling	Yes	Yes	No	Yes	No	No	No
48C	Qualifying advanced energy project	Yes	Yes	No	No	No	No	No
45Y	Clean Energy PTC	Yes	Yes	No	No	Yes	Yes	Yes
48E	Clean Energy ITC	Yes	Yes	No	No	Yes	Yes	Yes
45V	Clean Hydrogen	Yes	Yes	Yes (5-years)	No	Yes	No	No
45Z	Clean Fuel PTC	Yes	Yes	No	No	Yes	Yes	Yes
45X	Advanced Manufacturing PTC	No	Yes	Yes (5-years)	No	Yes	Yes	Yes
45U	Zero-Emission Nuclear PTC	Yes	Yes	No	No	No	Yes	No
45W	Qualified Commercial Clean Vehicles	No	No	No	Yes	No	No	No
48D	Semiconductor Manufacturing ITC	No	No	Yes	No	No	No	No

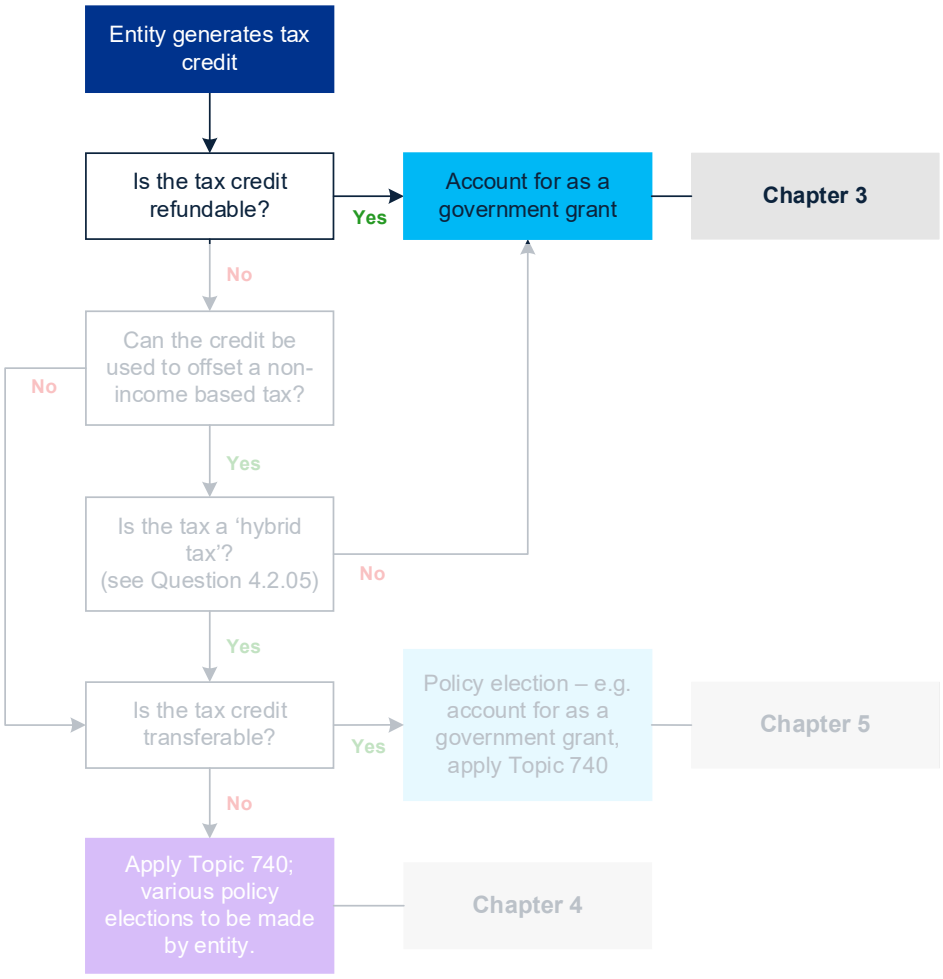
This table is not intended to capture all modifications to the tax credits under IRA and CHIPS. There may be additional changes outside of the categories presented above. For information, analysis and observations regarding the bill, refer to KPMG Washington National Tax's Incentives and Credits report.

3. Refundable credits

Detailed contents

Item significantly updated in this edition: #

3.1 How the standard works#



Certain jurisdictions, including the US, 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). The benefit from the refundable credit may take the form of a:

- direct cash payment from the government (if the entity does not have an income tax liability or its income tax liability is less than the value of the credit); or
- reduction to the income taxes payable that the entity would otherwise owe to the government.

Often an entity claims this benefit in connection with filing its income tax return, regardless of whether it receives a direct cash payment or offsets its income tax liability. Section 2.2 provides further discussion of which US federal tax credits are refundable and how the direct pay election works under US federal tax law.

Because the right to receive the benefit from a refundable credit does not depend on the existence of an income tax liability, we believe refundable credits should be accounted for as government grants, rather than as income taxes under Topic 740. Therefore, the benefit is not recorded as a reduction to income tax expense even if the entity uses the refundable credit to offset its income tax liability instead of receiving a cash refund.

However, US GAAP currently provides no specific guidance on how business entities should account for government grants. Therefore, diversity in practice exists, with many entities analogizing to one of three primary accounting models.

- **Grant model**, based on IAS 20, Accounting for Government Grants and Disclosure of Government Assistance under IFRS® Accounting Standards (section 3.2);
- **Contribution model**, based on Subtopic 958-605, Not-for-Profit Entities – Revenue Recognition (section 3.3); or
- **Gain contingency model**, based on Subtopic 450-30, Gain Contingencies (section 3.4).

Policy elections made in connection with the accounting for refundable credits should be consistent with prior policy elections for other 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. See section 3.3 of KPMG Handbook, Accounting changes and error corrections, for further discussion.

Future developments#

On November 19, 2024, the FASB issued a proposed ASU to establish authoritative guidance for the accounting for government grants received by business entities.

The ASU's key proposals would:

- prescribe an accounting model based on the main principles in IAS 20 (government grants and government assistance), with targeted revisions to areas such as scope and the recognition threshold;
- define a government grant as a transfer of a monetary or a tangible nonmonetary asset, other than an exchange transaction, from a government to a business entity;
- provide a recognition threshold under which a grant is recognized when it is probable the entity will comply with the grant's conditions and receive the grant;

- leverage existing disclosure requirements in ASC 832 (government assistance) for annual periods; and
- create specific recognition and measurement guidance in ASC 805 for certain government grant-related liabilities assumed in a business combination.

Under the proposal, entities could elect either a prospective or retrospective transition approach. If elected, the prospective approach would be applied to (1) all government grants not completed (i.e. all grant proceeds have not been recognized) as of the effective date and (2) all government grants entered into after the effective date. If elected, the retrospective approach would require a cumulative-effect adjustment to the opening balance of retained earnings at the beginning of the earliest period presented.

See KPMG Defining Issues, FASB proposes accounting guidance for government grants, for additional discussion.

3.2 Accounting for refundable credits under the grant model (IAS 20)#

Some entities apply IAS 20 by analogy to account for government grants. Under this approach, a refundable credit may be treated as a 'grant'.

We believe refundable 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. With the exception of measurement (see section 3.2.20), the accounting for nontransferable, refundable credits is the same as the accounting for transferable, refundable credits. Therefore, unless otherwise stated, references to 'refundable credits' within this chapter refer to both transferable and nontransferable refundable credits.

3.2.10 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.

Depending on what the refundable credit relates to, the benefit may be (1) recognized immediately in income or (2) deferred and subsequently amortized into income on a systematic basis in line with recognition of the costs that the credit is intended to defray.

The following table summarizes the timing of income recognition.

Credit relates to	Timing of recognizing the benefit in income
Depreciable asset	As the asset is depreciated/amortized.
Non-depreciable asset	Consistent with conditions related to the refundable credit. For example, if a refundable credit is related to the purchase of land on the condition that the entity constructs and operates a building on that land, the refundable credit is recognized in profit or loss as the building is depreciated.
Income to compensate for specific costs	On a systematic basis over the periods 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	In the period the entity concludes that the recognition criteria in IAS 20 are met for the refundable credit.

Question 3.2.10

How does an entity evaluate the 'reasonable assurance' threshold under IAS 20?

Interpretive response: We understand the SEC staff equates reasonable assurance under IAS 20 to 'probable' as used in Subtopic 450-20 (loss contingencies). In assessing whether 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 credit and meeting the conditions is primarily in its control and not highly susceptible to factors it cannot control (e.g. the judgment or actions of third parties, weather conditions);
- its ability to avoid repayment/recapture of the credit or other liabilities associated with a failure to comply with the credit's terms (i.e. a penalty); and
- the length of time until the uncertainty about meeting the conditions and receiving the refundable credit is expected to be resolved.

We believe this assessment should assume the relevant taxing authority has full knowledge of all pertinent information (i.e. detection risk should not be considered).

Question 3.2.20

Can an entity recognize a right to receive a refundable credit for costs the entity has not yet incurred?

Interpretive response: No. We believe it would be inappropriate to recognize a right to receive a refundable credit under US GAAP before incurring the costs that the credit is intended to defray. In practice, entities typically record a right to receive the refundable credit (asset) in proportion to the costs incurred (assuming the recognition criteria in IAS 20 are met). See Example 3.2.20.

3.2.20 Measurement#

In applying IAS 20 by analogy, we do not believe a nontransferable, refundable credit is a 'nonmonetary grant', which under IAS 20 is usually measured at fair value (see section 5.3.20). This is because a nontransferable, refundable credit is a fixed or determinable amount that may either be received in cash or used to reduce the entity's tax liability (which is a monetary liability). Therefore, nontransferable, refundable credits are measured at the amount of the credit.

However, the measurement of transferable, refundable credits depends on an entity's intent and ability to monetize the credit. If an entity has the intent and ability to sell (i.e., transfer) the credit, we believe it is generally a 'nonmonetary grant' under IAS 20 because the amount is not fixed or determinable (see Question 5.3.10 for additional guidance on measuring nonmonetary grants under IAS 20). However, if an entity has the intent and ability to use the credit, then it is accounted for in the same way as a nontransferable refundable credit, as discussed above.

Question 3.2.30
Are refundable credits discounted for the effects of time value of money?

Interpretive response: No. We believe an entity measures a refundable credit under IAS 20 without consideration to the time that may pass before the credit is received.

3.2.30 Presentation

In applying IAS 20 by analogy, refundable credits may be considered either 'grants related to assets' or 'grants related to income', depending on the costs they are intended to defray.

Under IAS 20:

- 'grants related to assets' are "government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets"; and
- 'grants related to income' are "government grants other than those related to assets."

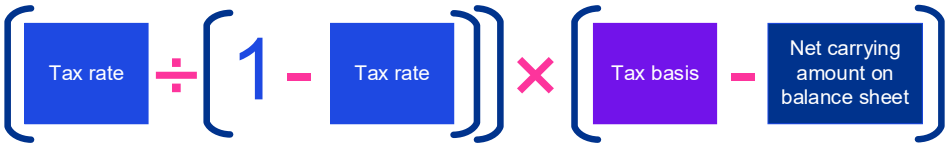
Grants related to assets

The benefit of a refundable credit that is a grant related to assets may be presented using either a net or gross presentation, based on an entity's policy election.

- **Net presentation:** deduct the credit from the carrying amount of the asset. Under this approach, the benefit is recognized in income through reduced depreciation expense.
- **Gross presentation:** present the credit separately as deferred income. Under this approach, the credit is amortized into income over the useful life of the asset, which may be presented, based on an entity's policy election, as either:
  - other income; 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 generally recognizes the related deferred taxes using the simultaneous equation approach, but there may be other acceptable approaches.

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



Example 3.2.10
Refundable ITC – Acquisition of qualifying asset

Background

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

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% ITC and comply with any requirements to avoid recapture or penalties.

Policy elections

ABC has an existing policy to account for government grants under the grant model (i.e. by analogy to IAS 20). In applying IAS 20, ABC determines that the ITC is a grant related to assets and elects to present the benefit as a reduction to the cost of the asset on the balance sheet, which will reduce the related depreciation expense on the income statement.

Other information

ABC has income taxes payable in Country X in excess of the available ITC and has determined it meets the right of setoff conditions in Subtopic 210-20.

There are no temporary differences to account for because:

- the ITC results in 100% tax basis reduction;
- the ITC reduces the carrying amount of the asset; and
- the qualifying property is depreciated over the same period and in the same manner for financial statement and income tax purposes.

ABC has a 21% statutory income tax rate.

Journal entries

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

	Debit	*Credit*
PPE	100,000,000	
Cash		100,000,000
To recognize the acquisition of the qualifying property.		
Income taxes payable	25,000,000	
PPE		25,000,000
To recognize the ITC (net presentation).		

The benefit of the ITC on the income statement will be recognized in the form of reduced depreciation expense related to the property, as illustrated below.

	Without ITC	With ITC
Carrying amount	100,000,000	75,000,000
Useful life	25 years	25 years
Annual depreciation expense	**4,000,000**	**3,000,000**

Example 3.2.20
Refundable ITC – Construction of qualifying asset over multiple periods

Background

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

On January 1, Year 1, ABC announces it will begin construction on a new manufacturing facility, which is a qualified asset for the ITC. The construction of the facility costs $75,000,000 and generates an $18,750,000 ITC. The construction begins in Year 1 and is completed on December 31, Year 2.

The facility is placed in service on January 1, Year 3 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 3 and expects to be in a net operating loss position and receive the ITC through a cash refund. In Year 4, after filing its Year 3 tax return, ABC receives the $18,750,000 payment of the ITC.

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

- in year 1, $25 million
- in year 2, $50 million

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

Policy elections

ABC has an existing policy to account for government grants under the grant model (i.e. by analogy to IAS 20). In applying IAS 20, ABC concludes that the ITC is a grant related to assets and elects to present the benefit as a reduction to the cost of the asset on the balance sheet, which will reduce the related depreciation expense on the income statement.

Other information

There are no temporary differences to account for because:

- the ITC results in 100% tax basis reduction;
- the ITC reduces the carrying amount of the asset; and
- the manufacturing facility is depreciated over the same period and in the same manner for financial statement and income tax purposes.

ABC has a 21% statutory income tax rate.

Journal entries

ABC records the following journal entries in Year 1.

	Debit	*Credit*
CIP	25,000,000	
Cash		25,000,000
To recognize the Year 1 costs incurred for the construction of the qualifying asset.		
Other asset[1]	6,250,000	
CIP		6,250,000
To recognize the ITC (net presentation).		

Note:

1. $25,000,000 qualifying expenditures × 25% ITC. See section 3.6 for additional guidance on the balance sheet presentation of the right to receive the refundable credit as an ‘other asset’.

ABC records the following journal entries in Year 2.

	Debit	*Credit*
CIP	50,000,000	
Cash		50,000,000
To recognize the Year 2 costs incurred for the construction of the qualifying asset.		
Other asset[1]	12,500,000	
CIP		12,500,000
To recognize the ITC (net presentation).		

Note:

1. $50,000,000 qualifying expenditures × 25% ITC.

ABC records the following journal entries in Year 3.

	Debit	*Credit*
PPE[1]	56,250,000	
CIP		56,250,000
To recognize facility being placed into service.		
Depreciation expense[2]	2,250,000	
PPE (accumulated depreciation)		2,250,000
To recognize depreciation expense.		
Notes: 1. $75,000,000 PPE, net of $18,750,000 ITC. 2. PPE, net ($75,000,000 – $18,750,000) ÷ 25 years.		

ABC records the following journal entries in Year 4.

	Debit	*Credit*
Depreciation expense[1]	2,250,000	
PPE (accumulated depreciation)		2,250,000
To recognize depreciation expense.		
Cash	18,750,000	
Other asset		18,750,000
To recognize the receipt of the ITC.		
Note: 1. PPE, net ($75,000,000 – $18,750,000) ÷ 25 years.		

Grants related to income

For refundable credits that are 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).

See Examples 3.5.10 and 3.6.10.

3.3 Accounting for refundable credits under the contribution model (Subtopic 958-605)

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 refundable credit may be treated as a ‘contribution’.

3.3.10 Recognition

Under Subtopic 958-605, if a contribution is unconditional, it is recognized immediately in income when received. In contrast, if a contribution is 'conditional', it is recognized in income when the conditions on which the contribution depends are substantially met.

Conditional contributions are those that include both:

- one or more barriers that must be overcome before the recipient is entitled to the benefit; and
- a right of return to the contributor for assets transferred or a right of release of the promisor from its obligation to transfer assets.

Contributions containing stipulations that are not clearly unconditional are presumed to be conditional under Subtopic 958-605.

Judgment is required to determine whether a refundable credit is a conditional or unconditional contribution based on the specific terms of the credit. An important consideration is whether the conditions that must be met to generate or to avoid recapture or penalty of a refundable credit constitute barriers. However, the ease with which a barrier may be met, or the entity's historical experience with meeting the barrier, are not factors to consider when determining whether the contribution is conditional. Further, conditions that are administrative and trivial in nature (e.g. filing a tax return) are not indicative of a barrier that would prevent recognition.

Additionally, entities will need to evaluate whether the refundable credit contains a right of return or a release from obligation. An agreement does not need to include the specific phrases 'right of return' or 'release from obligation'; however, the language in the agreement should be sufficiently clear to support a reasonable conclusion about when a recipient would be entitled to the transfer of assets. We believe entities should consider the recapture and/or penalty provisions relevant to the refundable credit when evaluating whether this criterion is met.

Question 3.3.10

How is 'substantially met' defined under Subtopic 958-605?

Interpretive response: Although Subtopic 958-605 requires that the conditions attached to a conditional contribution be substantially met before the contribution is recognized, it does not specifically define the term 'substantially met'. However, with respect to conditional promises to give, it states that a conditional promise is substantially met when it becomes unconditional. It further states that a transfer of assets after a conditional promise to give is made and before the conditions are met is the same as a transfer of assets that is a conditional contribution. [958-605-25-11, 25-13]

Therefore, we believe applying this guidance by analogy results in an entity deferring the recognition of the refundable credit until the credit becomes unconditional, which could occur once the examination, recapture or penalty period has lapsed. In such situations, an entity would account for any receipt of cash from the credit as a refundable advance (i.e. liability) until the credit has become unconditional.

3.3.20 Measurement

Contributions received are measured at fair value under Topic 820. Because recognition under the contribution model does not occur until the conditions on which the contribution depends are substantially met, in practice we expect that the fair value of a refundable credit generally will equal the actual proceeds received.

3.3.30 Presentation

Although Subtopic 958-605 states that contributions received can be classified as revenue or as a gain, we generally believe it would not be appropriate for a for-profit entity to present income related to a refundable credit as revenue.

3.4 Accounting for refundable credits under the gain contingency model (Subtopic 450-30)

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 refundable credit until it is realized or realizable. This generally happens when the claim is settled − i.e. proceeds are received and are not subject to refund. [450-30-25-1]

Therefore, in assessing whether the refundable credit is realized or realizable, an entity considers its ability to avoid recapture of the credit or a penalty. As a result, applying this guidance could result in an entity deferring the recognition of the benefit until the examination period, recapture period or penalty period has lapsed.

3.5 Accounting for bonus rates and adders

As further discussed in section 2.4, certain tax credits under the IRA have a base rate and a bonus rate. The IRA also contains adders that can increase the amount of the base and bonus rates. To qualify for bonus rates and adders, a taxpayer must meet certain requirements. The following table summarizes accounting considerations for these bonus rates and adders based on an entity's accounting policy election.

Accounting model	Accounting considerations
Grant model (see section 3.2)	IAS 20 does not address whether a grant should be separated into multiple grants (i.e. units of account). An entity needs to consider the facts and circumstances of the refundable credit in determining whether the base rate, bonus rate, and adders should be accounted for as an individual grant or multiple grants.
Contribution model (see section 3.3)	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 from bonus rates and adders until the compliance period has lapsed.
Gain contingency model) (see section 3.4)	An entity recognizes income related to the increased and bonus refundable credits when that income is realized or realizable (i.e. once the contingency has been resolved). Applying the guidance in Subtopic 450-30 could result in an entity deferring the recognition of the benefit from bonus rates and adders until the compliance period has lapsed.

Example 3.5.10
Refundable PTC and eligible bonus PTC

Background

ABC Corp operates in Country X, which provides a nontransferable 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.

Policy elections

ABC has an existing policy to account for government grants under the grant model (i.e. by analogy to IAS 20). In applying IAS 20, ABC determines that the ITC is a grant related to income and elects to present the benefit as other income.

Other information

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

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 PTC 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 during the construction period and asserts it is probable it will continue to meet the requirements during the 10-year PTC period. Therefore, a combined base and bonus PTC 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.

Journal entries

ABC records the following journal entries in Year 1.

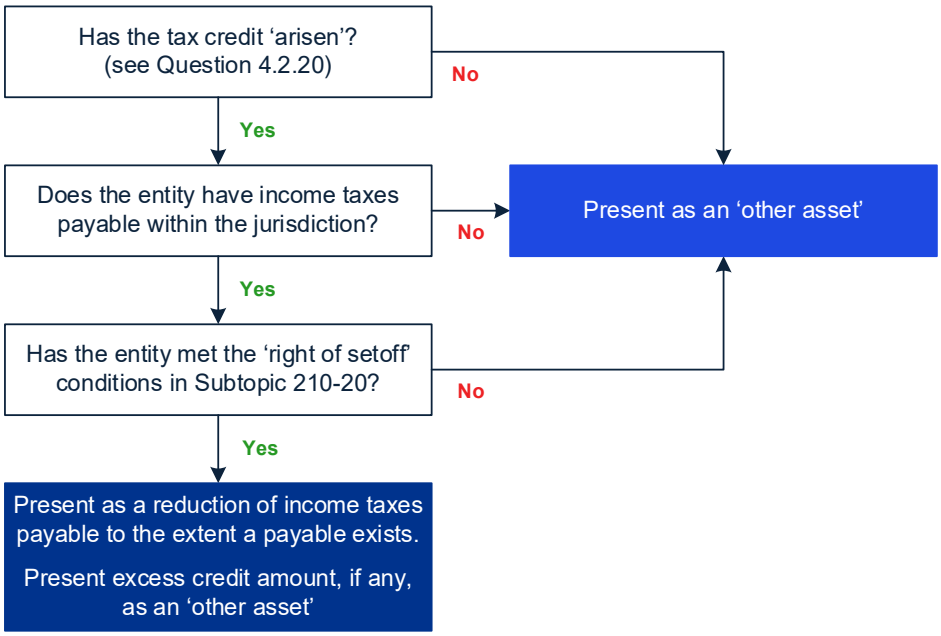
	Debit	*Credit*
Cost of sales	70,000,000	
Cash/Accounts payable		70,000,000
To recognize the cost of production and sale of the clean hydrogen.		
Other asset[1]	30,000,000	
Other income		30,000,000
To recognize base and bonus PTC as other income.		

Note:

1. 10,000,000 kilograms of qualified clean hydrogen × $3 ($0.60 per kilogram × 5 bonus rate). See section 3.6 for additional guidance on the balance sheet presentation of the right to receive a refundable credit as an 'other asset'.

3.6 Balance sheet presentation of a right to receive a government grant

An entity may meet the criteria to recognize a government grant before it receives cash. In such cases, it records a right to receive the government grant as a debit to the balance sheet; however, US GAAP currently provides no specific guidance on how to classify the right to a government grant on the balance sheet. We believe an entity should generally present the right to receive a government grant in the form of a tax credit in accordance with the following decision tree.



Example 3.6.10
Refundable credit recognized before it has arisen

Background

ABC Corp operates in Country X, which provides nontransferable PTCs 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.

Policy elections

ABC has an existing policy to account for government grants under the grant model (i.e. by analogy to IAS 20). In applying IAS 20, ABC concludes that the PTC is a grant related to income and elects to present the benefit as an offset to the related costs (initially inventory and later as cost of goods sold).

Other information

In Year 1, ABC produces qualifying battery cells at a cost of $5,000,000 and will generate a PTC of up to $1,000,000 as the battery cells are sold. ABC sells 80% of the battery cells produced during Year 1 and has complied with the relevant conditions to have $800,000 of the PTC arise under the tax laws in Country X in Year 1. ABC has contracted for the sale of the remaining battery cells in Year 2 and expects the remaining $200,000 of the PTC to arise in Year 2. At the end of Year 1, ABC concludes the recognition threshold in IAS 20 has been met for the entire amount of the PTC.

ABC has an income tax liability in Country X in excess of the available PTC in Year 1, and expects to in Year 2 as well. Therefore, ABC uses the PTC to offset

its income tax liability that would otherwise be due because it has determined that the right of setoff conditions in Subtopic 210-20 have been met.

Journal entries

ABC records the following journal entries in Year 1.

	Debit	*Credit*
Inventory	5,000,000	
Cash/Accounts payable		5,000,000
To recognize the production of the battery cells.		
Cost of goods sold[1]	4,000,000	
Inventory		4,000,000
To recognize cost of goods sold for the 80% of battery cells that were sold during Year 1.		
Income taxes payable[2]	800,000	
Other asset[3]	200,000	
Cost of goods sold		800,000
Inventory		200,000
To recognize PTC as offset to related costs.		

Notes:

1. 80% of the total battery cells produced in Year 1 are sold. The remaining 20% remain in inventory.
2. Because ABC sold 80% of the batteries and recognized the related costs in its income statement, it recognizes 80% of the PTC benefit as a reduction to such costs. Further, because this portion of the PTC arose in Year 1 and ABC has met the right of setoff conditions in Subtopic 210-10, it recognizes the offset as a reduction to its income taxes payable.
3. Although the recognition threshold under IAS 20 was met, 20% of the PTC did not arise in Year 1 because not all of the batteries were sold. Therefore, ABC recognizes this portion of the PTC as an other asset for its right to receive the PTC and a credit to inventory to reduce the related cost. Once the batteries are sold and the remaining 20% of the PTC arises under the tax law, we believe ABC should reclassify the other asset to income taxes payable on the balance sheet. The benefit will be recognized in the income statement because there will be lower cost of goods sold due to the credit to inventory recognized in Year 1.

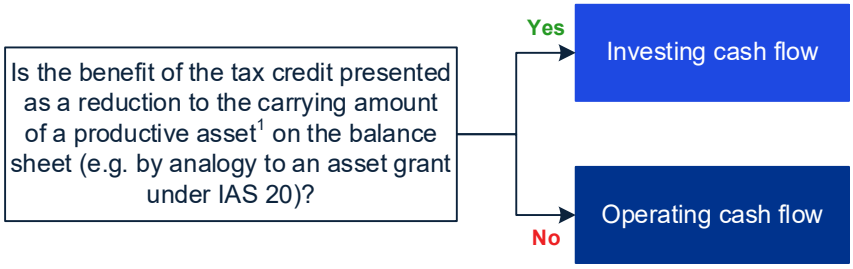
3.7 Statement of cash flows considerations

3.7.10 Classification of cash received from a refundable credit

Topic 230 provides no guidance on how to classify proceeds from government grants (and therefore refundable credits) in the statement of cash flows.

We believe it is generally appropriate to classify proceeds from a refundable credit consistent with the accounting treatment for the benefit of the credit, as illustrated in the following decision tree. This may or may not align with the

classification of the cash flows related to the costs that the refundable credit is intended to compensate the entity for.



[1] Assets held for or used in producing goods or services that are not part of an entity's inventory.

See section 23.3 of KPMG Handbook, Statement of cash flows, for further guidance on classifying cash flows related to government grants.

3.7.20 Income taxes paid

The statement of cash flows or accompanying notes must indicate the amount of income taxes paid in the period. This is done either as a disclosure, when the indirect method is used to prepare the statement of cash flows, or as a separate class of operating cash flows on the face of the statement, when the direct method is used.

We believe the amount of income taxes paid is net of refundable credits that were actually used in the period to reduce the amount of cash paid for income taxes. However, if instead the entity receives cash for a refundable credit (e.g. under the direct pay election), the portion of the credit refunded in cash (or to be refunded) does not reduce income taxes paid.

3.7.30 Noncash investing and financing activities

Investing and financing activities that affect recognized assets or liabilities but that do not result in actual cash receipts or payments are disclosed as noncash investing and financing activities. Such disclosures are summarized in a schedule or in narrative form on the face of the statement of cash flows, or in the notes to the financial statements by reference to the statement of cash flows.

These disclosures may be required in the period that an entity initially recognizes a refundable credit, depending on its selected accounting policies. For example, if an entity recognizes a refundable credit upon purchasing or constructing a depreciable asset and elects to present the credit as a contra-asset (i.e. by analogy to an asset grant under IAS 20), it discloses the transaction as a noncash investing activity if (1) the cash proceeds are not received in the same period or (2) the entity uses the refundable credit to reduce its income taxes payable.

3.8 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.

Topic 832 disclosure requirements include: [832-10-50-3, 50-4]

- 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, including, but not limited to, the duration or period of the agreement, commitments made by both parties, other contingencies, and if there are any other provisions that would allow the government entity to recapture the amounts awarded.

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.

3.9 Foreign refundable credits#

United Kingdom RDEC

The United Kingdom (UK) 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 research and development (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 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 3.9.10
UK RDEC

Background

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.

Other information

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	–
Deferred tax expense (benefit)	–[3]	–[3]
Income tax expense	325,000	–
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.

Ireland R&D credit

The Irish government provides an R&D credit to provide entities with an incentive to develop a sustainable basis for long-term employment growth by reducing the economic costs of undertaking R&D activities. The amount of the credit is 25% of qualifying R&D expenditures. Qualifying expenditures are defined as incremental to R&D expenditures in the 2003 base year. The amount of the credit is limited to the greater of (1) income taxes payable by the entity for the 10 years prior to the accounting period in which the qualifying expenditure was incurred and (2) the amount of PAYE, pay-related social insurance (PRSI) and levies (payroll taxes) the entity is required to remit in the period in which the qualifying expenditure was incurred.

Effective January 1, 2009, the amount of the tax credit may be recovered by offsetting it against the current year's corporation tax liability, and any unused credit may be recovered to the extent of any corporation tax for the preceding accounting period. Any remaining excess is paid by the Revenue Commission in three installments as follows.

1. A payment of 33% of the excess is the first installment;
2. The remaining excess is then used to first reduce the corporation tax liability of the subsequent year and, if any excess still remains, a second installment amounting to 50% of that excess is paid to the entity, and;
3. Any further excess is then used to reduce the corporation tax liability of the subsequent year and, if any excess still remains, it is paid to the entity as a third installment.

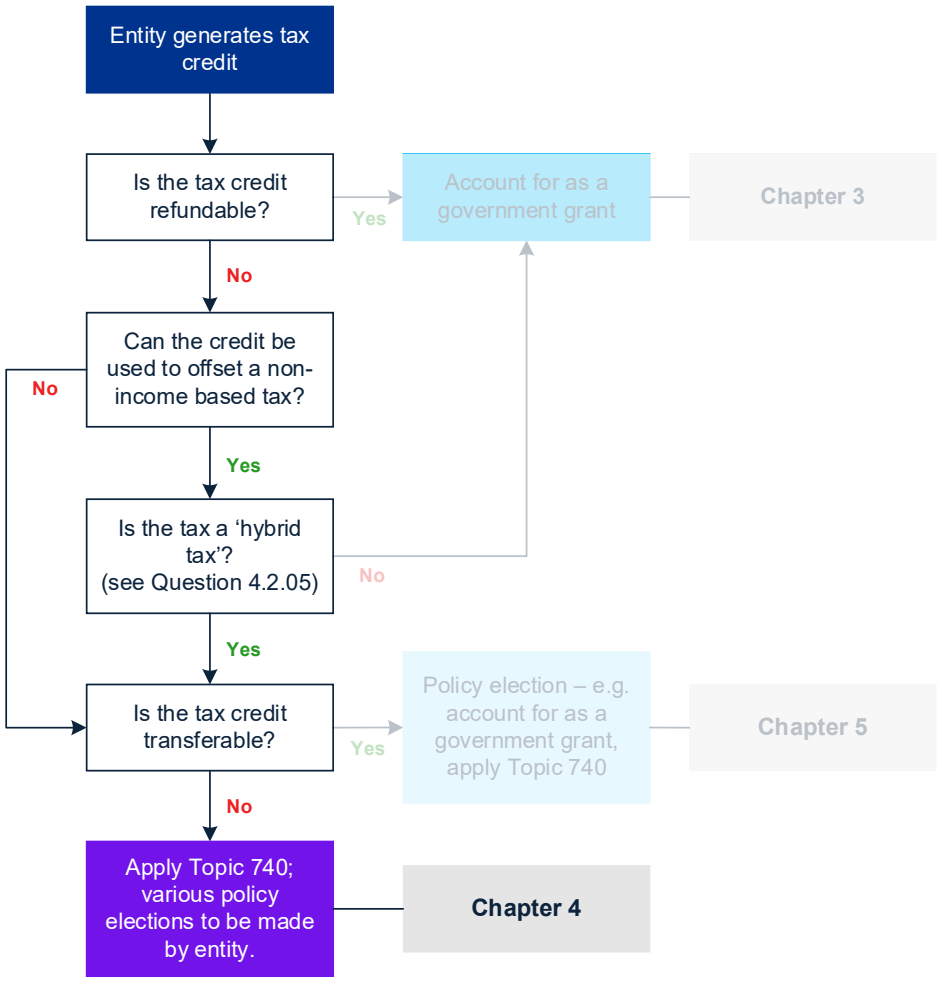
Topic 740 only applies to taxes based on income. For the R&D credit, income taxes paid in the prior 10 years represents the upper limit of amounts that can be credited rather than a basis for determining the amount of tax credits. In addition, the income tax system is only a methodology to administer the refunds to eligible parties. As a result, we believe the tax credit is not income-based (i.e. is outside the scope of Topic 740) and, therefore, the benefit of the credit is not presented as a reduction of income tax expense.

4. Nonrefundable, nontransferable tax credits

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

4.1 How the standard works#



The term 'nonrefundable, nontransferable tax credits' refers 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.

Once a credit arises (see Question 4.2.20), the accounting depends on the type of tax credit, as summarized in the following table.

ITCs	Owners of qualifying property that generate ITCs have several policy elections available, which may result in the tax benefits being recognized in a variety of ways, including any of the following: • 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 credits[1]	The full income tax benefit is generally recognized when the credit arises.

Note:

1. Other credits include, but are not limited to, PTCs, certain research and experimentation credits, work opportunity credits and FTCs.

4.2 Accounting for nonrefundable, nontransferable credits

4.2.10 Overview

The accounting for nonrefundable, nontransferable ITCs differs from the accounting for other nonrefundable, nontransferable credits.

ITCs

Nonrefundable, nontransferable ITCs are accounted for under Topic 740, which provides a policy choice as to the method for recognizing the benefit (i.e. income statement recognition). [740-10-25-45 – 25-46]

- **The flow-through method:** The entity recognizes the ITC benefit when it arises.
- **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.*

The decision to apply the flow-through method or the deferral method is the foundational policy choice under Topic 740. If the deferral method is elected, an entity must then make a series of additional policy choices in recognizing the ITC benefit 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.

Question 4.2.05**

Are nonrefundable tax credits that can be used against non-income based taxes outside the scope of Topic 740?

Interpretive response: Generally, yes. Taxes that are imposed solely based on a non-income measure, such as capital or payroll, are outside the scope of Topic 740. Accordingly, we believe a tax credit that can be used to offset such obligations is also outside of Topic 740's scope and should be accounted for as a government grant.

However, some jurisdictions may impose "hybrid taxes" that are based on the greater or lesser of an income-based measure and a non-income-based measure. For example, a jurisdiction may impose a tax based on the greater of 4.5% of an entity's taxable income or 0.25% of its equity. We believe the accounting for a tax credit that can be used to offset a hybrid tax depends on whether it is transferable. If it is not transferable, an entity accounts for the credit under Topic 740, even if those credits are ultimately used against a payment based on something other than income (e.g. an entity makes a payment based on its equity under a 'greater of' regime). Conversely, if the credit is transferable,

it may be accounted for under Topic 740 or as a government grant based on the entity's accounting policy election (see chapter 5).

See KPMG Handbook, Accounting for income taxes, for further discussion of taxes that are only partially based on income.

Question 4.2.10
What is an ITC?

Interpretive response: An ITC is a tax incentive provided by governments to encourage businesses to invest in specific types of assets (e.g. renewable energy assets). To be considered an ITC, the incentive needs to be in the form of a tax credit, and not an exclusion or deduction from taxable income.

An ITC is typically calculated as a percentage of the cost of the qualifying asset and may be subject to recapture if that asset is sold within a certain period of time (e.g. within five years of the placed in service date). Generally, the cost of the qualifying asset for US federal ITCs will be its tax basis using the capitalization rules of IRC Section 263A. However, individual ITC programs may have specific rules that modify which costs are eligible. Other grants or incentives that reduce the asset's tax basis will also reduce the ITC.

The underlying asset is accounted for under other GAAP (e.g. Topic 360). Generally, ITCs relate to PPE, which is initially measured at cost, depreciated over its useful life, and evaluated for impairment, as necessary.

Other tax credits

For nonrefundable, nontransferable credits other than ITCs, an entity recognizes a credit's benefit in income tax expense (benefit) in the year the credit arises. [740-10-25-46]

Question 4.2.20
When does a tax credit 'arise' under Topic 740?

Background: Topic 740 states that treating an ITC as a reduction of federal income taxes of the year in which the credit arises (the flow-through method) is an acceptable approach. However, it does not define what it means for a credit to 'arise'.

Interpretive response: We believe a tax credit arises when (1) it becomes available under the tax law to reduce an entity's income tax liability (i.e. its available for use) and (2) the recognition and measurement principles in Topic 740 are met.

Available for use

We do not believe that 'available for use' means an entity must be able to actually utilize the entire amount of the credit on its current year tax return (e.g. if the amount of the credit exceeds its current year income tax liability). Instead, we believe available for use means that *if* the entity had a sufficient amount of taxable income or tax liability, it *could* utilize the entire amount under the relevant tax law.

Further, the tax law in certain jurisdictions may limit the amount of the credit that can be used in any given tax year. It is important to understand these limitations in determining whether the credit is available for use.

- **Limitation is based on a percentage of an entity's taxable income or tax liability:** We do not believe that would preclude recognition of the credit. This is because the entire credit is technically available for use under the tax law as long as an entity has sufficient taxable income or tax liability and an entity could hypothetically take certain actions that would increase those amounts to utilize the entire credit.
- **Limitation is based on a percentage of the credit itself:** An entity may be precluded from recognizing the benefit of the credit that exceeds the current year limitation. This is because that amount is not available to reduce the entity's income tax liability, regardless of any actions taken by the entity.

Additionally, some tax credits may be 'granted' to an entity in one year but cannot begin to be used on its tax return until a future year. For example, an entity is granted a tax credit in Year 1 but cannot begin utilizing the credit until Year 3. In such situations, we believe an entity should not recognize the tax credit until the year that it becomes available for use on its tax return (Year 3 in the example from the preceding sentence).

Recognition and measurement principles in Topic 740

To determine whether it can recognize a tax 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 that the tax benefit of the credit will be sustained 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. See Question 4.2.30 if the credit is subject to recapture or penalty should the entity not continue to comply with specified requirements during a compliance period.

See KPMG Handbook, Accounting for income taxes, for further discussion on accounting for uncertainty in income taxes (from paragraph 3.015).

Question 4.2.30

Do ongoing compliance requirements prevent the recognition of tax credits under Topic 740?

Background: 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.

Interpretive response: To recognize the tax credit, we believe management must:

- 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; and
- expect to continue to comply with the tax credit's ongoing requirements during the compliance period.

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.

See Question 4.2.50 for further discussion on changes in estimates when an entity applies the deferral method and KPMG Handbook, Accounting for income taxes, for further discussion on accounting for uncertainty in income taxes (from paragraph 3.015).

4.2.20 ITCs and other tax credits – Flow-through method

When an entity accounts for tax credits other than ITCs or elects to apply 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.

Question 4.2.40

How are differences between the financial statement carrying amount of an asset and its tax basis accounted for under the flow-through method?

Background: Although a tax credit accounted for under the flow-through method does not reduce the financial statement carrying amount of the underlying asset to which it relates, the tax basis of such asset may be reduced by some, or all, of the tax credit under the relevant tax law. In such cases, a taxable temporary difference will exist for which an entity must establish a deferred tax liability.

Interpretive response: It depends on the entity's policy election. We believe an entity may elect to record the deferred tax effects either (1) immediately in income tax expense or (2) as an adjustment to the financial statement carrying amount of the asset.

If the entity elects to adjust the financial statement carrying amount of the asset, the amount of 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

Background

ABC Corp operates in Country X, which provides nonrefundable, nontransferable 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. 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). Nothing further is required of ABC to earn or retain the credit.

Policy elections

ABC elects the flow-through method.

Journal entries

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

	Debit	*Credit*
PPE	100,000	
Cash		100,000
To recognize acquisition of qualifying asset.		
Income taxes payable	50,000	
Current tax benefit		50,000
To recognize ITC benefit.[1]		

Note:

1. There is no temporary difference 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.

	Debit	*Credit*
Depreciation expense[1]	20,000	
PPE (accumulated depreciation)		20,000
To recognize depreciation expense.		
Income taxes payable	4,200	
Current tax benefit		4,200
To recognize the tax benefit of depreciation.		

Note:

1. The financial statement carrying amount of the asset is depreciated by 20% each year.

Effect on Year 1 financial statements ($)

Assets		**Net Income**	
PPE, net	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[1]	271%
		Years 2 to 5 effective tax rate	21%
Liabilities			
Income taxes payable	(54,200)		
Decrease	**(54,200)**		
Increase in net assets	**34,200**		

Note:

1. Effective tax rate is calculated as income tax (benefit) (54,200) ÷ taxable income (loss) (20,000) = effective tax rate of 271%. Because ABC has elected the flow-through method, the effective tax rate in future years will not be impacted.

Example 4.2.20
ITC with tax basis reduction – Flow-through method

Background

ABC Corp operates in Country X and receives from Country X a nonrefundable, nontransferable ITC for 50% of the purchase price of certain qualifying assets. The ITC 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 ITC (i.e. the ITC is in lieu of otherwise available depreciation deductions for that portion of the purchase price of the asset). Unused ITCs 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. Nothing further is required of ABC to earn or retain the ITC of $50,000. 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 ITC), and the financial statement carrying amount of the assets is $100,000. ABC recognizes a deferred tax liability for the temporary difference.

Policy elections

ABC elects to account for the ITC under the flow-through method and to recognize the initial deferred tax effects immediately in income tax expense.

Other information

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 and its taxable income after depreciation expense are calculated as follows:

Year 1			
Financial statement pretax income		**Taxable income**	
Income before depr.	60,000	Income before depr.	60,000
Depreciation expense[1]	(20,000)	Depreciation expense[2]	(10,000)
Book pretax income	**40,000**	**Taxable Income**	**50,000**

Notes:

1. The financial statement carrying amount of the asset of $100,000 is depreciated by 20% each year.
2. The tax basis of the asset of $50,000 is depreciated by 20% each year.

ABC has no other permanent or temporary differences.

Journal entries

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

	Debit	*Credit*
PPE	100,000	
Cash		100,000
To recognize acquisition of qualifying asset.		
Deferred tax asset[1]	50,000	
Deferred tax liability[2]		10,500
Deferred tax benefit		39,500
To recognize ITC benefit.		

Notes:

1. The deferred tax asset is the amount of the tax credit generated that is available for use.
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) × 21%).

ABC records the following journal entries during Year 1.

	Debit	*Credit*
Depreciation expense[1]	20,000	
PPE (accumulated depreciation)		20,000
To recognize depreciation expense.		
Current tax expense[2]	2,625	
Income taxes payable		2,625
To recognize income taxes payable.		
Deferred tax liability[3]	2,100	
Deferred tax expense[4]	5,775	
Deferred tax assets[5]		7,875
To recognize ITC utilization.		

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 of taxable income × 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 financial statement

carrying amount − $40,000 tax basis) × 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 net deferred tax asset at December 31, Year 1 minus $39,500 net deferred tax asset at January 1, 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		**Net Income**	
PPE	80,000	EBITDA	60,000
Deferred tax asset	33,725	Depreciation 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.

Principle: The ITC benefits are deferred and recognized over the productive life of the qualifying property			
Step 1: Initially defer the ITC benefit			
Reduce carrying amount of asset (contra-asset)		Recognize deferred income (liability)	
Step 2: Recognize deferred taxes on the temporary difference that arises from initially deferring the ITC benefit			
Reduce carrying amt. of asset (contra-asset)	Recognize immediately in income tax exp. (ben.)	Reduce carrying amt. of asset (contra-asset)	Recognize immediately in income tax exp. (ben.)
Step 3: Recognize the deferred ITC benefit over the productive life of the qualifying property			
Depreciation expense	Income tax exp. (ben.)	Depreciation expense	Income tax exp. (ben.)	No policy choice: Income tax expense (benefit)
Step 4: Adjust deferred taxes based on the temporary difference that exists at the reporting date			

Step 1: Initially defer the ITC benefit

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]

To the extent an entity expects to use the ITC to reduce its current year or a prior year income tax liability, we believe it has an accounting policy choice to recognize the offsetting entry as an adjustment to income taxes refundable (payable) or as a deferred tax asset. Alternatively, to the extent the ITC is expected to be carried forward and used on future income tax returns, we believe the offsetting entry should be recorded as a deferred tax asset.

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

As discussed in Step 1, the deferral of the ITC benefit (net of valuation allowance) will either reduce the carrying amount of the asset or result in the recognition of a liability. Additionally, the tax law may provide for a reduction in the tax basis of the asset equal to a percentage or the full amount of the credit. If the reduction in the tax basis of the asset is less than the amount of the deferral, a deductible temporary difference will arise. We believe an entity may recognize the deferred

tax effect of that temporary difference immediately in income tax expense (benefit) or by further adjusting the financial statement carrying amount of the asset. [740-10-25-20(f)]

If the entity elects to further adjust the financial statement carrying amount of the asset, the amount of 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 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 3.2.30 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: We believe an entity may present the periodic benefit in income tax expense (benefit) or in depreciation expense.
- Deferred income in Step 1: An entity presents the periodic benefit in income tax expense (benefit). There is no policy choice.

Step 4: 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).

Question 4.2.50

How are changes in estimates related to the expected amount of income tax benefit to be realized from tax credits recognized?

Background: After a tax credit has been recognized, an entity may change its estimate of the amount of income tax benefit that will be realized, for example due to a change in judgment about the realization of a credit or unrecognized tax benefits related to a credit.

Interpretive response: When an entity applies the deferral method, we believe it does not adjust the carrying amount of the acquired asset or a deferred income liability due to changes in estimates about the amount of income tax benefit that will be realized. Instead, we believe the effect of such adjustments should be recognized in income tax expense in the period in which such changes in judgments arise.

Example 4.2.30

ITC – Deferral method

Background

This fact pattern is the same as Example 4.2.10.

ABC Corp operates in Country X, which provides nonrefundable, nontransferable ITCs for the development of certain renewable energy facilities. The amount of the ITC is 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 ITC and unused ITCs can be carried over indefinitely. 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). Nothing further is required of ABC to earn or retain the ITC.

Policy elections

ABC elects the deferral method. The table below summarizes the other policy elections available under the deferral method. In addition, ABC expects to utilize the entire ITC on its current year tax return and has elected to present it as a reduction of income taxes payable.

Journal entries

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.

Policy choices:						
Presentation of deferred ITC:	**Contra-asset**				**Deferred Income**	
Recognition of deferred taxes:	**Contra-asset**		**Immediate**		**Contra-asset**	**Immediate**
Presentation of ITC benefit:	**Depreciation**	**Income tax expense**	**Depreciation**	**Income tax expense**	**Income tax expense**	
Journal entries						
Entries on Jan 1, Year 1						
Qualifying asset acquired:						
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)
Defer ITC benefit (Step 1):						
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)
Recognize deferred taxes (Step 2):						
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)

Policy choices:						
Presentation of deferred ITC:	**Contra-asset**				**Deferred Income**	
Recognition of deferred taxes:	**Contra-asset**		**Immediate**		**Contra-asset**	**Immediate**
Presentation of ITC benefit:	**Depreciation**	**Income tax expense**	**Depreciation**	**Income tax expense**	**Income tax expense**	
Entries during Year 1						
Recognize ITC benefit (Step 3):						
Dr Depreciation expense[2]	7,342	17,342	10,000	20,000	17,342	20,000
Cr PPE (accum. depreciation)	(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)
Recognize tax benefit of depr:						
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)
Recognize change in deferred taxes (Step 4):						
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)**

Policy choices:						
Presentation of deferred ITC:	**Contra-asset**				**Deferred Income**	
Recognition of deferred taxes:	**Contra-asset**		**Immediate**		**Contra-asset**	**Immediate**
Presentation of ITC benefit:	**Depreciation**	**Income tax expense**	**Depreciation**	**Income tax expense**	**Income tax expense**	
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						
Depreciation 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:

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, the deferred tax effect is calculated using the simultaneous equation.

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). For example, in cases where the ITC benefit is presented in income tax expense (benefit), depreciation expense is computed based on the PPE carrying amount **excluding** the contra-asset account.
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).

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.

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.

Method	Presentation of deferred ITC benefit	Deferred tax for initial basis difference	Recognition of ITC benefit	Outcome
Flow-through	N/A	Contra-asset (simultaneous equation)	N/A	Full tax benefit when the credit arises and higher pretax depreciation expense than electing to recognize initial basis difference immediately.
Flow-through	N/A	Immediate in Income tax expense (benefit)	N/A	Full tax benefit when the credit arises and an ongoing regular effective tax rate on pretax depreciation expense. (Example 4.2.20)
Deferral	Contra-asset	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 combinations of policy elections. (Example 4.2.30)
Deferral	Contra-asset	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. (Example 4.2.30)
Deferral	Deferred income	Contra-asset (simultaneous equation)	Income tax expense (benefit)	

Method	Presentation of deferred ITC benefit	Deferred tax for initial basis difference	Recognition of ITC benefit	Outcome
Deferral	Contra-asset	Immediate in Income tax expense (benefit)	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 most of the other combinations of policy elections. (Example 4.2.30)
Deferral	Contra-asset	Immediate in Income tax expense (benefit)	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)
Deferral	Deferred income	Immediate in Income tax expense (benefit)	Income tax expense (benefit)	

4.3 Other application issues

4.3.10 Accounting for bonus rates and adders

As further discussed in section 2.4, certain tax credits under the IRA have a base rate and a bonus rate. The IRA also contains adders that can increase the amount of the base and bonus rates. To qualify for bonus rates and adders, a taxpayer must meet certain requirements.

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

PTC	Recognized in the year they arise (see Question 4.2.20).
ITC – Flow-through	Recognized in the year they arise.
ITC – Deferral	Initially deferred on the balance sheet in the year they arise, and then 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 bonus rates and adders. 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 Disclosures

Topic 740 states it is essential that full disclosure be made of the method followed to account for ITCs (deferral method or flow-through method) and amounts involved, when material. To comply with this disclosure requirement, we believe that in addition to disclosing the method used, an entity should also disclose the accounting policy elections that were made when applying the selected method (e.g. where the ITC benefit is presented in the income statement). [740-10-50-20]

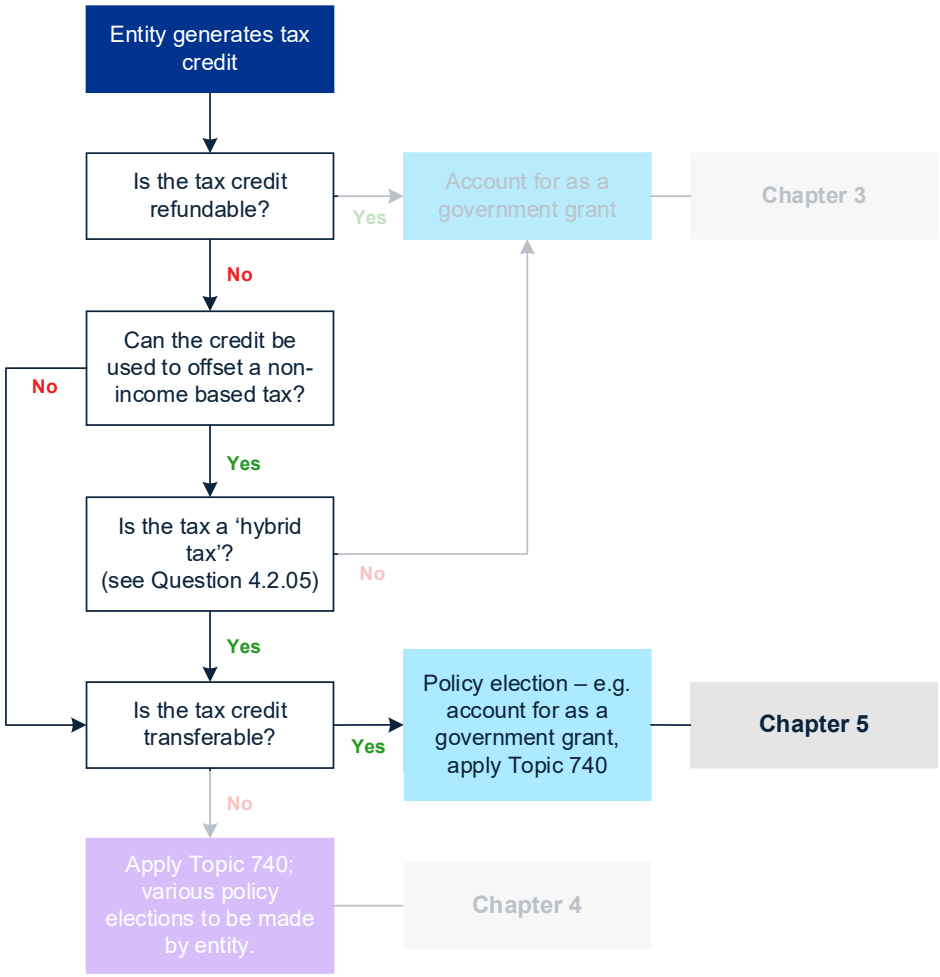
Additionally, an entity's disclosure of the significant components of income tax expense attributable to continuing operations must include the impact of ITCs. [740-10-50-9]

5. Transferable credits

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

5.1 How the standard works#



Certain jurisdictions, including the US, allow an entity to make a one-time transfer of an income tax credit (or portions of the credit) to another unrelated taxpayer (the buyer) in exchange for cash. Section 2.3 discusses which US federal tax credits are transferable and how the third-party transfer election works under US federal tax law.

In many jurisdictions, including the US, the credit becomes nonrefundable and nontransferable to the buyer. We expect the buyer 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 transferable credits by the reporting entity.

Transaction	Refundable	Nonrefundable
Generation of transferable credit	Account for as a government grant	Acceptable approaches to accounting include: • apply Topic 740 (income taxes) • account for as a government grant
Transfer (sale) of transferable credit	Subtopic 610-20 (sales of nonfinancial assets)	
Purchase of transferable credit that is nonrefundable, nontransferable to the acquirer	Topic 740 applies	

Any 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.

5.2 Accounting for the generation of transferable, refundable 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. With the exception of measurement, the accounting for transferable, refundable credits is the same as the accounting for nontransferable, refundable credits, which is discussed in chapter 3.

The initial measurement of a transferable, refundable credit under the grant model depends on whether an entity has the intent and ability to transfer the credit. If such intent and ability exists, the transferable, refundable credit is measured at either its fair value or a nominal amount, depending on an entity's policy election, consistent with the accounting for nonrefundable, transferable credits. See Question 5.3.10 for further guidance on measuring a tax credit when an entity has the intent and ability to transfer the credit.

5.3 Accounting for the generation of nonrefundable, transferable credits

Based on discussions with the FASB staff, we believe there is more than one acceptable approach to account for nonrefundable, transferable credits generated by an entity.

We believe it is most appropriate to apply Topic 740 to nonrefundable, transferable credits, regardless of how an entity ultimately expects to monetize them. However, we believe it is acceptable to elect a policy to account for nonrefundable, transferable credits as government grants.

5.3.10 Accounting for nonrefundable, transferable credits under Topic 740

Under Topic 740, the accounting for the following credits depends on their nature.

- **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.

If an entity chooses to consider expected transfers in assessing the realizability of credits, then only the expected proceeds from those transfers may be considered in determining whether a valuation allowance is needed and, if so, the amount of the valuation allowance. That is, entities may not look to other possible sources of taxable income (e.g. deferred tax liabilities) to support the realizability of the credits.

If an entity disregards expected transfers in assessing the realizability of credits or it doesn't expect to transfer the credits, it must consider its ability to generate sufficient taxable income in determining whether a valuation allowance is necessary. If no valuation allowance is deemed necessary, then an entity may need to recognize a loss when the credit is sold.

The accounting for the generation of the credit using Topic 740 is illustrated in Examples 5.4.10 and 5.4.20.

5.3.20 Accounting for nonrefundable, transferable credits as government grants#

If an entity elects to account for nonrefundable, transferable credits as government grants, it has to apply an accounting model by analogy because US GAAP does not currently provide specific guidance on how business entities are to recognize, measure or present government grants. Business entities commonly apply one of the following three accounting models by analogy:

- **Grant model**, based on IAS 20 (see Question 5.4.10 and section 3.2);
- **Contribution model**, based on Subtopic 958-605 (see section 3.3); and
- **Gain contingency model**, based on Subtopic 450-30 (see section 3.4).

However, on November 19, 2024, the FASB issued a proposed ASU to establish authoritative guidance for the accounting for government grants received by business entities (see section 3.1). This project could eliminate the ability to apply the above models (or any other model) by analogy to government grants in the scope of a final ASU resulting from this proposal.

Question 5.3.10#

How are transferable tax credits measured when applying the grant model?

Interpretive response: It depends on an entity's intent and ability to monetize the credit.

Intent and ability to sell

If the entity intends, and has the ability, to sell the tax credit to a third party, we believe the credit is generally a 'nonmonetary grant' under IAS 20 because the amount to be realized for the credit is not fixed or determinable. Under IAS 20, an entity makes a policy election to recognize a nonmonetary grant at either its fair value or a nominal amount. [IAS 20.23]

Although there is a policy choice in IAS 20, 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 a nominal amount. This is because fair value is noted in IAS 20 as the usual approach and these types of one-time transferable tax credits likely were not contemplated in the promulgation of IAS 20.

For a transferable tax credit, we would expect the fair value to equal the price that would be received upon the sale of the transferable credit in an orderly transaction between market participants at the measurement date. Conversely, we would expect the nominal amount for a transferable credit to be $0.

Further, IAS 20 does not provide specific guidance on the measurement date for nonmonetary grants. In the absence of specific requirements, an entity should apply judgment, based on the relevant facts and circumstances, to determine the date at which to measure the fair value of the grant asset. We believe that one acceptable approach is to measure the fair value at the recognition date – i.e. when there is reasonable assurance that the entity will comply with the relevant conditions and the grant will be received. Under this approach, an entity is not expected to subsequently remeasure the grant asset.

Intent and ability to use

If an entity intends, and has the ability, to use the tax credit to reduce its income tax liability, we generally do not believe the tax credit is a nonmonetary grant under IAS 20 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). Therefore, the transferable tax credit would be measured at the amount of the credit.

Example 5.3.10
Transferable tax credits, offsets income tax liability – Grant model

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 ITC, subject to the discretion of the taxing authority, to generate the ITC.

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

Policy elections

ABC elects to account for nonrefundable, transferable credits as government grants. It has an existing policy to account for government grants under the grant model (i.e. by analogy to IAS 20). In applying IAS 20, ABC concludes that the ITC is a grant related to assets and elects to present the ITC as a reduction of the cost of the asset. Based on these policy elections, the benefit of the ITC is recognized in profit or loss through a reduction of depreciation expense.

Journal entries

In Year 1, ABC applies for and receives an allocation of the ITC for the construction of a solar energy facility. It incurs $50,000,000 of qualifying construction costs, which will generate an ITC 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 ITC's relevant conditions and (2) the ITC will be received. Therefore, the IAS 20 recognition requirements have been met to record the ITC even though the credit has not arisen under the tax law (i.e. because the assets have not been placed in service).

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 exists as of the end of Year 1.

ABC records the following journal entries in Year 1.

	Debit	*Credit*
CIP	50,000,000	
Cash		50,000,000
To recognize the costs incurred for the construction of the qualifying asset.		
Other asset[1, 2]	3,000,000	
CIP		3,000,000
To recognize the ITC (net presentation).		

Notes:

1. ABC presents the ITC as an 'other asset' rather than as a reduction of income taxes payable because the ITC is not available for use on its current year tax return. See section 3.6 for further discussion on the balance sheet presentation of tax credits accounted for as government grants.
2. ABC concludes the ITC is not a nonmonetary grant, because it has the ability and intent to use it to reduce its income tax liability, and measures it at the full credit amount.

On January 1, Year 2, ABC places the facility in service and the ITC arises under the tax law.

ABC's tax liability before applying the ITC 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 ITC and has concluded that the right of offset criteria in Subtopic 210-20 have been met.

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

	Debit	*Credit*
PPE	47,000,000	
CIP		47,000,000
To recognize that the qualifying asset was placed in service.		

ABC records the following journal entries in Year 2.

	Debit	*Credit*
Depreciation expense[1]	9,400,000	
PPE (accumulated depreciation)		9,400,000
To recognize the depreciation expense.		
Income taxes payable[2]	1,974,000	
Current tax benefit		1,974,000
To recognize the tax benefit of tax depreciation to be taken on the Year 2 tax return.		
Income taxes payable[3]	1,875,000	
Other asset		1,875,000
To recognize the credit used during Year 2.		
Notes: 1. [$50,000,000 qualifying asset − $3,000,000 credit] ÷ 5 years. 2. Tax depreciation of $9,400,000 [$47,000,000 tax basis ÷ 5 years] × 21%. 3. The ITC can only be used to offset 75% of the $2,500,000 tax liability.		

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.

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

5.3.30 What does it all mean?**

The myriad of accounting models available for transferable credits, and policy elections within each model, can make it challenging to understand how an entity's choices ripple through the financial statements.

To simplify the analysis, it helps to first align the terminology. Under Topic 740, transferable credits are classified as ITCs or PTCs. Under IAS 20, they are classified as grants related to assets or grants related to income. While the labels may differ, the meanings are generally the same – ITCs ≈ asset grants, PTCs ≈ income grants. This classification is important because it drives which accounting policies are available under each standard.

The effects of a transferable credit on the financial statements depends on which accounting model is applied and the policy elections made when applying that policy. Depending on an entity's choices, the effects can be the exact same, or very different. At a high level, the choice between Topic 740 and IAS 20 – and the related policy elections – drives three things:

- **when** the tax credit is recognized in the income statement;
- **where** it is reflected in the income statement; and
- **how much** is in the income statement.

Some policy elections will have the same effects on the financial statements, while others will have very different effects, as explained below. (For purposes of illustrating the similarities and differences, we have focused on ITCs/asset grants.)

When

Under IAS 20, the benefit of a grant related to assets is recognized over the asset's useful life. However, under Topic 740, an entity could choose to recognize the benefit of an ITC immediately by electing the flow-through method. These choices have very different effects on when the benefit of a transferable credit is recognized in the income statement.

Alternatively, under Topic 740, an entity could choose to recognize the benefit of an ITC over time using the deferral method. This choice generally results in no difference between Topic 740 and IAS 20 with respect to when the benefit of a transferable credit is recognized in the income statement.

Where

Under IAS 20, an entity presents the benefit of a grant related to assets in pretax income (either as a reduction to expense or as other income). However, under Topic 740, an entity could choose to present the benefit of an ITC in income tax expense (benefit), either by applying the flow-through method or by making certain policy elections under the deferral method. These choices have very different effects on where the benefit of a transferable credit is recognized in the income statement.

Alternatively, an entity could choose to present the benefit of an ITC in pretax income under Topic 740 by making certain policy elections under the deferral method. While this choice results in including the benefit in pretax income under both IAS 20 and Topic 740, there could be a difference in *where* the benefit is presented *within* pretax income. Under IAS 20, the entity could choose to present the benefit as other income, while under Topic 740, the benefit is presented as a reduction to expense

How much
Under IAS 20, when an entity has the intent and ability to sell transferable credits, they may be measured at either their fair value or nominal amount. Otherwise, they are measured at face value. Under Topic 740, a transferable credit is initially measured at face value and assessed each period for realizability. If an entity chooses a policy to consider expected transfers in its valuation allowance assessment, then it remeasures the benefit of the transferable credit each period as its expectation of the potential sales proceeds changes.

5.4 Accounting for the transfer (sale) of the credit

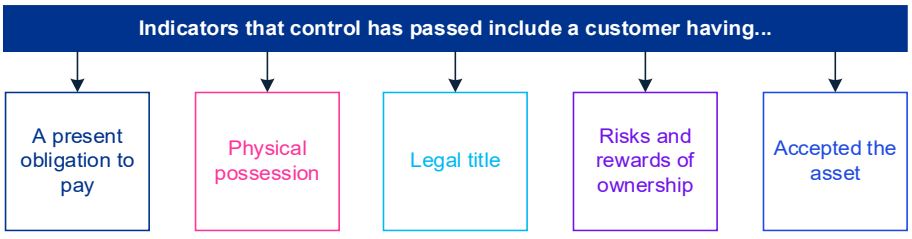
We believe it is generally appropriate to consider the derecognition guidance in Subtopic 610-20 (sales of nonfinancial assets) when accounting for the sale of a transferable credit.

Subtopic 610-20 uses the principles in Topic 606 (revenue from contracts with customers) and provides incremental guidance on recognizing the gain or loss upon derecognition of a nonfinancial asset. See chapter 17 in KPMG Handbook, Revenue recognition, for further discussion on accounting for the derecognition of nonfinancial assets.

Importantly, an entity must have first concluded that it initially met the *recognition* criteria with respect to a transferable credit before it can apply the *derecognition* guidance in Subtopic 610-20. The initial recognition criteria depend on an entity's selected accounting policy for transferable credits as discussed in section 5.3.

Derecognition accounting

Under Subtopic 610-20, a nonfinancial asset is derecognized and a gain or loss is recorded at the point in time the counterparty obtains control of the asset. 'Control' refers to the counterparty's ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Entities evaluate the control principle and the control indicators in paragraph 606-10-25-30 to determine the point in time at which a counterparty obtains control of an asset.



The above indicators are not necessarily individually determinative, nor are they a list of conditions that have to be met. Topic 606 does not suggest that certain indicators should be weighted more heavily than others, nor does it establish a hierarchy that applies if only some of the indicators are present. Instead, the indicators are applied to an entity's specific fact pattern and in some facts and

circumstances certain indicators will be more important than others. The relative weight of the indicators depends on the effect they have on a customer's ability to direct the use of and obtain substantially all the benefits from an asset. [606-10-25-30]

See sections 7.2 and 7.5 in KPMG Handbook, Revenue recognition, for further discussion on the transfer of control.

Given the nature of certain transferable tax credits, it can be challenging to determine when control of the credit transfers to the counterparty. For example, it may be difficult to determine when the counterparty has obtained the ability to direct the use of a tax credit given that it generally cannot pledge or re-sell the credit (i.e. the ability to pledge or re-sell would generally provide evidence that the counterparty has obtained the ability to direct the use of an asset). This restriction is different from some environmental credits that may be sold multiple times before they are retired.

While all relevant facts and circumstances should be considered, we believe the following are important factors in determining when control of a US federal tax credit transfers to the counterparty.

- **Completion of the transfer election statement:** As further explained in section 2.3, to transfer a US federal tax credit, a seller must perform a series of steps including registering the eligible credit property with the IRS, completing a transfer election statement, and filing its annual income tax return. Additionally, to claim a transferred credit, the buyer must obtain the registration number of the eligible credit, obtain the transfer election statement from the seller, and file its income tax return. Completion of the transfer election statement may provide evidence that the buyer has obtained legal title and/or risks and rewards of ownership of the transferable credit because the buyer is the only entity the IRS will recognize as having the right to claim the credit on its tax return.
- **Payment terms:** The counterparty's present obligation to pay for the asset is an indicator that control has transferred, but generally is not sufficient on its own to conclude that control has transferred. However, given the nature of some transferable tax credits (e.g. they can only be transferred once) and the lesser relevance of some control indicators, a counterparty's present obligation to pay will be an important indicator of control to consider along with the specific terms and conditions of the sale agreement.

  The terms and conditions of the sale agreement will generally govern when the counterparty (buyer) is obligated to pay for the tax credit, which could be upon generation of the credit, completion of the transfer election statement, or some other point in time. If the entity has received cash from the buyer or if payment is due within a short timeframe, that may provide evidence of the buyer's present obligation to pay. However, the existence of extended payment terms in the agreement may indicate that the buyer has not obtained control of the tax credit.

The accounting for the transfer of a credit is illustrated in Examples 5.4.10, 5.4.20 and 5.4.30.

Question 5.4.10

Can a sale of a transferable tax credit be recognized before the buyer and seller have filed their tax returns?

Interpretive response: Yes. We generally believe that the act of actually filing the tax returns is an administrative step that would not be indicative of when control of the tax credit is transferred to the buyer.

However, entities should carefully consider all of the relevant terms and conditions of the sale agreement in evaluating the point in time that control transfers. For example, if the sale agreement specifies that the buyer is not obligated to pay for the tax credit until it files its tax return, that may indicate that control does not transfer until that point in time.

Question 5.4.20

Are indemnification provisions relevant when determining whether control of a tax credit transfers to a buyer?

Background: Tax credit sale agreements may contain clauses that indemnify the buyer if the tax credits are recaptured or disallowed by the relevant taxing authority.

Interpretive response: Generally, we do not believe the inclusion of indemnification provisions in a sale agreement would preclude derecognition under Subtopic 610-20. However, judgment will be required to determine if such indemnification provisions represent a guarantee under Subtopic 460-10 (guarantees) or variable consideration under Topic 606. See Question 2.3.10 in KPMG Handbook, Revenue recognition, for further discussion on determining whether guarantees and indemnifications are in the scope of Topic 606 (and similarly Subtopic 610-20) or Topic 460.

If the indemnification provision is related to the entity's performance (e.g. whether they produced the green product eligible for the credit) and is deemed to be variable consideration under Topic 606, the variable consideration 'constraint' is applied when measuring the amount of gain or loss to be recorded. When applying the constraint, an entity includes an estimated amount of variable consideration in the measurement of the gain or loss only if it is probable that a subsequent change due to the uncertainty caused by the provision would not result in a significant reversal of the sales proceeds. See section 5.3.40 in KPMG Handbook, Revenue recognition, for further discussion of the constraint on variable consideration.

Therefore, due to the inherent uncertainty in some aspects of the tax law and an entity's ability to meet certain eligibility requirements, there could be instances in which the amount of consideration included in the measurement of the gain or loss is significantly constrained, resulting in a loss (or a greater amount of loss) when a transferable credit is derecognized. This outcome depends on the

uncertainty related to the specific credits and the facts related to the entity's eligibility, but a loss may be more likely when an entity applies Topic 740 to account for the generation (initial recognition) of the transferable credit. This is because Topic 740 uses a 'more likely than not' recognition threshold whereas Topic 606 uses a 'probable' threshold, which is a higher degree of certainty, when constraining variable consideration.

Question 5.4.30

Will an entity always recognize a gain or loss upon de-recognizing a transferable credit?

Interpretive response: No. 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, it recognizes changes in the estimated proceeds as an adjustment to its valuation allowance.

Question 5.4.40

How are gains or losses from the transfer of a tax credit presented?

Interpretive response: It depends on whether the entity accounted for the generation of the tax credit under Topic 740 or as a government grant.

Topic 740

If an entity elects not to consider expected transfers of the credits in assessing their realizability as part of the valuation allowance analysis, we believe it is most appropriate for the entity to recognize the gain or loss from a transfer in income tax expense or benefit. However, we also believe it is acceptable to recognize this gain or loss in pretax income or loss.

Government grant

We believe an entity that accounts for the credits as government grants outside the scope of Topic 740 should recognize the gain or loss from a transfer of the credits in pretax income or loss.

Example 5.4.10

Transferable tax credits, sold to third party – Topic 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 ITC, subject to the discretion of the taxing authority, to generate the ITC.

The ITC 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 ITC. The ITC 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 (see section 4.2.10). ABC also elects to record temporary differences between the financial statement carrying amount of an ITC qualifying asset and its tax basis immediately in income tax expense (see Question 4.2.40).

Journal entries

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

ABC records the following journal entry in Year 1.

	Debit	*Credit*
CIP	50,000,000	
Cash		50,000,000
To recognize the costs incurred for the construction of the qualifying asset.		

Importantly, although ABC applied for and received the allocation of credits, it cannot recognize a DTA under Topic 740 because the ITC is not available for use in Year 1 (i.e. the ITC has not arisen because the assets have not been placed in service). See Question 4.2.20 for further discussion of when tax credits arise under Topic 740.

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

ABC's Year 2 tax liability before applying the ITC 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 ITC in Year 2.

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

	Debit	*Credit*
PPE	50,000,000	
CIP		50,000,000
To recognize that the qualifying asset was placed in service.		
Income taxes payable[1]	1,875,000	
Current tax benefit		1,875,000
To recognize the ITC used in Year 2.		
Deferred tax asset[1]	1,125,000	
Deferred tax benefit		1,125,000
To recognize the benefit of the remaining ITC expected to be used in future years.		
Deferred tax expense[2]	630,000	
Deferred tax liability		630,000
To recognize the deferred tax liability related to the facility.		

Notes:

1. In Year 2, ABC uses $1,875,000 of the $3,000,000 ITC. The $1,875,000 used during the year reduces income taxes payable. The remaining ITC of $1,125,000 is recorded as a deferred tax asset because it has arisen under the relevant tax laws but cannot be used in the current year.
2. A deferred tax liability is recognized for the difference between the financial statement carrying amount and the tax basis of the acquired asset (($50,000,000 − $47,000,000) × 21%).

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 ITC for $1,035,000 (92% of face value) to a third party in Year 3 and elects to make a portion of the ITC transferable.

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

ABC records the following journal entries in Year 2.

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

	Debit	*Credit*
Deferred tax liability	126,000	
Deferred tax benefit[2]		126,000
To recognize the reduction of the deferred tax liability related to the facility.		
Deferred tax expense	90,000	
DTA – Valuation allowance[3]		90,000
To recognize the valuation allowance.		

Notes:

1. Tax basis of $47,000,000 ($50,000,000 cost, less $3,000,000 of ITC generated) over five years results in tax depreciation of $9,400,000 × 21%.
2. Reduction of the deferred tax liability based on the difference between the DTL at the end of Year 2 ($504,000) and the DTL at the beginning of Year 2 ($630,000).
3. The DTA – Valuation allowance is the difference between the remaining ITC available of $1,125,000 and the expected proceeds from the sale of the ITC of $1,035,000 ($1,125,000 × 92%). None of the DTL would support recognition of the DTA because it is expected to be transferred.

On January 1, Year 3, ABC sells the remaining ITC 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.

	Debit	*Credit*
Deferred tax expense[1]	22,500	
DTA – Valuation allowance		22,500
To adjust the valuation allowance to the revised expected proceeds prior to the sale.		
Cash	1,012,500	
DTA – Valuation allowance	112,500	
Deferred tax asset		1,125,000
To recognize the sale of the ITC to a third party.		

Note:

1. The difference between the carrying amount of the remaining ITC of $1,035,000 and the expected proceeds from the ITC's sale of $1,012,500.

Example 5.4.20
Transferable tax credits, sold to third party – Topic 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 ITC, subject to the discretion of the taxing authority, to generate the ITC.

The ITC 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 ITC. The ITCs 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 to account for ITCs. ABC has elected the following policy choices under the deferral method (see section 4.2.30 for further discussion of the policy choices).

Step	Policy choice
Initially defer the ITC benefit	Reduce carrying amount of asset with an offsetting entry to deferred tax assets
Recognize the deferred ITC benefit over the productive life of the qualifying property	Depreciation expense

Journal entries

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 an ITC of $3,000,000 (6% of eligible capitalized costs) when the facility is placed in service.

ABC records the following journal entry in Year 1.

	Debit	*Credit*
CIP	50,000,000	
Cash		50,000,000
To recognize the costs incurred for the construction of the qualifying asset.		

Importantly, although ABC applied for and received the allocation of ITCs, it cannot recognize a DTA because the ITC is not available for use in Year 1 (i.e. the ITC has not arisen because the assets have not been placed in service). See Question 4.2.20 for further discussion of when tax credits arise under Topic 740.

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

ABC's Year 2 tax liability after depreciation but before applying the ITC is $2,500,000, 75% of which can be offset by ITCs. Accordingly, ABC will use $1,875,000 of the $3,000,000 in ITCs.

Since ABC has elected to apply the deferral method and to reduce the carrying amount of the asset, ABC concludes there is not a temporary difference for the PPE when the assets are placed in service.

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

	Debit	*Credit*
PPE	50,000,000	
CIP		50,000,000
To recognize that the qualifying asset was placed in service.		
Deferred tax asset	3,000,000	
PPE		3,000,000
To initially defer the ITC.		

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 ITC for $1,035,000 (92% of face value) to a third party in Year 3 and elects to make a portion of the ITC transferable.

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

ABC records the following journal entries in Year 2.

	Debit	*Credit*
Depreciation expense[1]	9,400,000	
PPE (accumulated depreciation)		9,400,000
To recognize the depreciation expense.		
Income taxes payable[2]	1,974,000	
Current tax benefit		1,974,000
To recognize the benefit of tax depreciation to be taken on the Year 2 tax return.		
Income taxes payable	1,875,000	
Deferred tax expense	1,875,000	
Current tax benefit		1,875,000
Deferred tax asset		1,875,000
To recognize the utilization of part of the ITC.		
Deferred tax expense	90,000	
DTA – Valuation allowance[3]		90,000
To recognize a valuation allowance, considering the proceeds from the sale of the ITC.		

Notes:

1. [$50,000,000 qualifying asset − $3,000,000 tax credit] ÷ 5 years.
2. Tax depreciation of $9,400,000 × 21%.
3. The DTA – Valuation allowance is the difference between the remaining ITC available of $1,125,000 and the expected proceeds from the ITC's sale of

$1,035,000 ($1,125,000 × 92%). See Question 4.2.50 for discussion of changes in estimates.

On January 1, Year 3, ABC sells the remaining ITC 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.

	Debit	*Credit*
Deferred tax expense[1]	22,500	
DTA – Valuation allowance		22,500
To adjust the valuation allowance to the revised expected proceeds prior to the sale.		
Cash	1,012,500	
DTA – Valuation allowance	112,500	
Deferred tax asset		1,125,000
To recognize the sale of the ITC to a third party.		

Note:

1. The difference between the carrying amount of the remaining ITC of $1,035,000 and the expected proceeds from the sale of the ITC of $1,012,500.

Example 5.4.30
Transferable tax credits, sold to third party – Grant model

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 ITC, subject to the discretion of the taxing authority, to generate the ITC.

The ITC 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 ITC. The ITC 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 ITC to a third party and estimates its fair value is 90% of the ITC.

Policy elections

ABC elects to apply government grant accounting to nonrefundable, transferable ITCs. It has an existing policy to account for government grants under the grant model (i.e. by analogy to IAS 20). In applying IAS 20, ABC concludes that the ITC is a grant related to assets and elects to present the ITC as a reduction of the cost of the asset, and to measure nonmonetary grants at fair value. Based on these policy elections, the benefit of the grant is recognized in profit or loss through reduced depreciation expense.

Journal entries

In Year 1, ABC applies for and receives an allocation of an ITC for the construction of a solar energy facility. It incurs $50,000,000 of qualifying construction costs, which will generate an ITC 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 ITC's relevant conditions and (2) the ITC will be received. Therefore, the IAS 20 recognition requirements have been met to record the ITC even though the ITC has not arisen under the tax law (i.e. because the assets have not been placed in service).

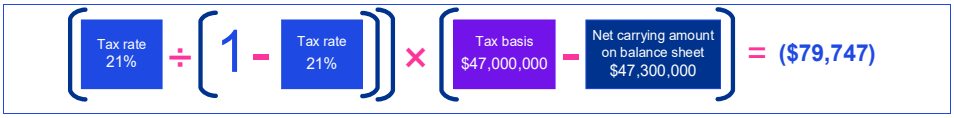
ABC considers the future reduction in tax basis of $3,000,000 that would occur upon placing the facility in service when measuring temporary differences as of the end of Year 1.

ABC records the following journal entries in Year 1.

	Debit	*Credit*
CIP	50,000,000	
Cash		50,000,000
To recognize the costs incurred for the construction of the qualifying asset.		
Other asset[1, 2]	2,700,000	
CIP		2,700,000
To recognize the ITC (net presentation).		
CIP[3]	79,747	
Deferred tax liability		79,747
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.		

Notes:

1. ABC measures the transferable credit 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 presents the transferable credit as an 'other asset' because the credit has not arisen. See section 3.6 for additional guidance related to the balance sheet presentation of a right to receive 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.



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

At the end of Year 2, ABC sells the ITC for $2,760,000 (92% of the ITC 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.

	Debit	*Credit*
PPE[1]	47,379,747	
CIP		47,379,747
To recognize that the qualifying asset was placed in service.		
Note: 1. [$50,000,000 of qualifying costs − $2,700,000 of ITC + $79,747 resulting from the simultaneous equation in Year 1].		

ABC records the following journal entries in Year 2.

	Debit	*Credit*
Depreciation expense[1]	9,475,949	
PPE (accumulated depreciation)		9,475,949
To recognize the depreciation expense.		
Income taxes payable[2]	1,974,000	
Current tax benefit		1,974,000
To recognize the benefit of tax depreciation to be taken on the Year 2 tax return.		
Deferred tax liability[3]	15,949	
Deferred tax benefit		15,949
To recognize change in deferred taxes.		
Cash	2,760,000	
Other asset		2,700,000
Other income[4]		60,000
To recognize the sale of the ITC to a third party and the related gain.		
Notes: 1. [$50,000,000 qualifying asset − $2,700,000 ITC + $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 ITC of $2,700,000 and proceeds from the sale of $2,760,000.		

5.5 Accounting for the purchase of the credit#

An entity (buyer) may purchase a tax credit that is nonrefundable and nontransferable to the buyer. We generally believe the buyer recognizes a purchased tax credit when it obtains control of such credit (see section 5.4).

To the extent the buyer expects to use the credit to offset its current year or a prior year income tax liability, we believe it has an accounting policy choice to present the purchased credit as either an adjustment to income taxes refundable (payable) or as a deferred tax asset. Alternatively, to the extent the purchased credit is expected to be carried forward to be utilized on future income tax returns, we believe it should be presented as a deferred tax asset. No matter the presentation elected, such a purchased credit is measured under Topic 740.

In general, we expect the buyer to purchase the credit for an amount that is less than its full tax value. The difference between the purchase price, including direct costs to acquire the credit, and the Topic 740 measurement of the purchased credit is recognized as a deferred credit. Derecognition (or reversal) of the deferred credit in income tax expense occurs in proportion to the reversal of the associated deferred tax asset. Reversal of the deferred credit is generally included in determining the buyer's estimated annual effective tax rate unless the credit is acquired in an annual period after the tax year in which it is utilized.

Example 5.5.10
Purchase of tax credits

This is a continuation from Example 5.4.30.

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

XYZ has a policy to present purchased tax credits as an adjustment to income taxes refundable (payable) to the extent it expects to offset the credit against its current year or a prior year income tax liability.

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 deferred credit. The reversal of the deferred credit during the year will be reflected 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;
- $240,000 discount as a deferred credit;
- $160,000 (($2,000,000 ÷ $3,000,000) × $240,000) of the deferred credit that will reverse in Year 2 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 ÷ $3,000,000) × $240,000) of the deferred credit as income tax expense in future periods in proportion to the reversal of the $1,000,000 deferred tax asset.

5.5.10 Accounting for indemnification arrangements, including seller indemnifications and third-party insurance policies**

In certain jurisdictions, including the US, an entity that purchases a tax credit becomes the primary obligor for any underpayment due to the taxing authority when the tax credit is utilized. As a result, it may seek indemnification arrangements to help mitigate that potential risk (i.e. that the taxing authority may disallow some or all of the credit claimed on the purchaser's tax return). Generally, the indemnification is either in the form of:

- a direct contractual arrangement with the seller of the credits;
- the direct purchase of an insurance policy by the buyer from a third-party provider; or
- a third-party insurance policy arranged by the seller with the buyer as the insured.

Regardless of whether the buyer obtains indemnification, it must account for and disclose any potential uncertainties associated with the benefit of the credit in accordance with accounting for uncertainties in income taxes under Topic 740. That is, the indemnification arrangement is not considered when accounting for the tax uncertainty under Topic 740.

Accounting for seller-provided indemnification arrangements

Topic 740 does not directly address how to account for indemnification arrangements. However, Topic 805 addresses the buyer's accounting for an indemnification arrangement in a business combination and states that the acquirer: [805-20-25-27]

- recognizes an indemnification asset at the same time it recognizes the indemnified item; and
- measures the indemnification asset on the same basis as the indemnified item, subject to the potential for an allowance for uncollectible amounts and any contractual limitations on the indemnified amount (referred to as the 'mirror approach').

We believe it is acceptable to analogize to Topic 805's guidance when accounting for a seller-provided indemnification related to the purchase of a tax credit. Therefore, to the extent the buyer is required to recognize an unrecognized tax benefit liability related to the purchased credit under Topic 740, it recognizes an indemnification asset at the same time and for the same amount, subject to its assessment of the collectibility of the indemnification asset and any contractual limitations on the indemnified amount. This 'mirror approach' results in a gross up of the buyer's balance sheet because the indemnification asset is recognized separately from the unrecognized tax benefit liability.

Additionally, while any subsequent adjustments to the unrecognized tax benefit liability and related indemnification asset are equal (provided there are no collectibility or contractual limitation considerations), separately presenting the effects of those subsequent adjustments in the income statement on a gross basis is required. Subsequent adjustments to any unrecognized tax benefits are reflected in income tax expense (benefit), and subsequent adjustments to indemnification assets are reflected within pretax income (loss). In addition, subsequent adjustments for the accrual of interest and penalties follows the entity's policies for the presentation of interest and penalties related to income taxes, while any related adjustment to the indemnification asset is presented in pretax income (loss). Thus, while a dollar-for-dollar change in both an unrecognized tax benefit liability and a related indemnification asset generally offset each other in net income, both pretax income and an entity's effective tax rate are generally impacted.

Further, public business entities include the unrecognized tax benefit, gross of any indirect effects or indemnifications:

- as part of the tabular rollforward of the total amounts of unrecognized tax benefits from the beginning to the end of the period; and
- within the total amount of unrecognized tax benefits that would impact the effective tax rate, if recognized, in accordance with paragraph 740-10-50-15A.

Entities also need to consider additional disclosures, including but not limited to, the terms of any material contractual indemnification arrangements.

Example 5.5.20**
Purchase of tax credits with seller-provided indemnification

ABC Corp acquires $10,000,000 of transferable credits from XYZ Corp for $9,500,000 on December 31, Year 1. ABC Corp expects to fully utilize the purchased credits against its Year 1 income tax liability. Assume ABC Corp recognized an unrecognized tax benefit liability of $1,000,000 upon acquisition of the credit as a result of the recognition and measurement analysis of the acquired credits under Topic 740.

However, as part of the purchase and sale agreement, XYZ Corp agreed to indemnify ABC Corp against any and all losses suffered as a result of utilizing the credit (i.e. in the event the taxing authority disallowed ABC Corp's utilization of the credit). There are no contractual limitations or collectibility concerns related to the indemnification.

ABC Corp records the following journal entry on December 31, Year 1.

	Debit	*Credit*
Income taxes payable	10,000,000	
Indemnification asset[1]	1,000,000	
Cash		9,500,000
Current tax expense		500,000
Income taxes payable – Noncurrent		1,000,000
To record the acquisition of the credit, the current year utilization, the unrecognized tax benefit and the indemnification asset		

Note:

1. The indemnification asset is recognized at the same time, and measured on the same basis, as the indemnified item (in this case, the unrecognized tax liability).

This journal entry results in gross presentation of the indemnification arrangement and the related income tax liabilities in the financial statements.

The indemnification asset needs to be evaluated periodically for any changes in the expected indemnification amount. ABC Corp measures the indemnification asset on the same basis as the indemnified item, subject to management's assessment of collectibility and contractual limitations. As noted above, subsequent changes to an indemnification asset are recognized in earnings in the period the unrecognized tax benefit is remeasured or all or a part of the asset is deemed uncollectible due to changes in the seller's creditworthiness.

Accounting for buyer-purchased insurance policies

When the buyer separately purchases an insurance policy from a third-party insurance provider, the purchase of the insurance is a separate transaction from

the acquisition of the transferable credit being insured. That is, the cost to obtain the insurance policy is not included as a direct cost of the transferable credit.

In determining the appropriate accounting treatment for the purchased insurance contract, it is first necessary to determine if the policy related to the transferable credit meets the requirements to be accounted for:

- as insurance in accordance with Topic 944 (financial services – insurance);
- as a derivative in accordance with Topic 815 (derivatives and hedging); or
- under other applicable guidance.

Assuming the policy meets the requirements under Topic 944 to be accounted for as insurance by the insurance provider, we believe the buyer accounts for the purchased insurance contract by applying the guidance in Subtopic 720-20. Under Subtopic 720-20, the accounting differs based on whether the insurance policy is retroactive (i.e. it covers risks that existed as of the date the credit is acquired) or prospective (i.e. it covers future risks). If the policy covers both retrospective and future risks, each component is accounted for separately.

	Retroactive policy	Prospective policy
Premiums paid	Expensed immediately	Recognized as a prepaid asset and expensed over the coverage period
Receivable for expected recoveries	Recognized for the expected recoveries related to the underlying insured event. That is, the buyer records an insurance receivable at the same time, and for the same amount, as the unrecognized tax benefit liability, provided the underlying event is covered under the insurance policy and recovery of the loss is probable.	
Gain for expected recoveries	If the receivable established for expected recoveries exceeds the amounts paid for the insurance, the resulting gain is deferred. That is, the amount of gain recognized is limited to the amount of premiums paid. If the amount and timing of receiving the insurance proceeds can be reasonably estimated, the deferred gain is amortized using the interest method over the period the entity expects to receive the insurance proceeds. If the amount and timing of receiving the insurance proceeds cannot be reasonably estimated, the	Recognized upon establishment of the receivable for expected recoveries.

	Retroactive policy	Prospective policy
	deferred gain is recognized based on the proportion of actual insurance proceeds received to the estimate of total insurance proceeds expected to be received.	

Accounting for seller-purchased insurance policies

In practice, it is common for the purchase price of a transferable credit to include a third-party insurance policy arranged by the seller. Under these arrangements, the seller acquires the third-party insurance with the buyer as the beneficiary. In these situations, the purchase agreement includes both the transferable credit and the third-party insurance purchased on the buyer's behalf.

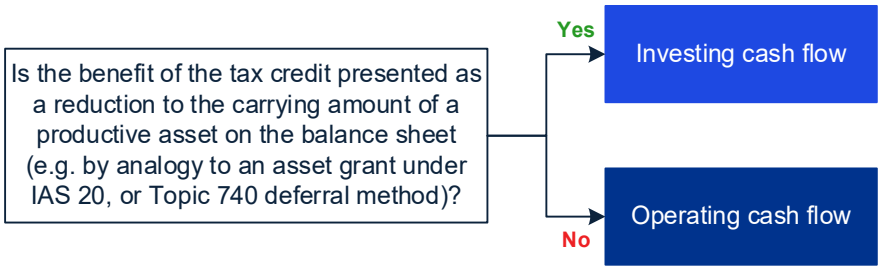
We believe the accounting for a seller-purchased insurance policy should generally follow the accounting discussed above for buyer-purchased insurance policies. That is, the purchase of the transferable credit and the insurance policy should be accounted for separately. As such, the cost of the insurance should generally be bifurcated from the purchase price and accounted for separate from the acquired credit.

5.6 Statement of cash flows presentation and disclosures

5.6.10 Proceeds received from the sale of a transferable credit

Topic 230 provides no guidance on how to classify proceeds from the sale of transferable credits in the statement of cash flows.

Consistent with our views for the classification of proceeds from refundable credits (see section 3.7.10), we believe it is generally appropriate to classify proceeds from the sale of a transferable credit generated directly by the entity consistent with the accounting treatment for the benefit of the credit, as illustrated in the following decision tree.



5.6.20 Purchases of transferable credits

We believe cash outflows related to purchases of transferable credits are generally presented in operating cash flows. This is because the buyer must account for purchased tax credits as income taxes under Topic 740 if the purchased tax credit is nonrefundable and nontransferable to the buyer.

5.6.30 Income taxes paid

The statement of cash flows or accompanying notes must indicate the amount of income taxes paid in the period. This is done either as a disclosure when the indirect method is used to prepare the statement of cash flows, or as a separate class of operating cash flows on the face of the statement when the direct method is used. After adoption of ASU 2023-09, Improvements to Income Tax Disclosures, the disclosure of the amount of income taxes paid is disaggregated by domestic federal, domestic state, and foreign. Further disaggregation is required by individual jurisdiction if a specific threshold is met.

We believe that if an entity sells a transferable credit that it accounted for under Topic 740, it is acceptable to include the proceeds in its disclosure of income taxes paid (and for the individual jurisdiction to which the credit relates after the adoption of ASU 2023-09). Likewise, if a buyer accounts for a purchased tax credit under Topic 740, we believe it is acceptable to include the amount paid in its disclosure of income taxes paid (and for the individual jurisdiction to which the credit relates after the adoption of ASU 2023-09). Entities should clearly disclose when such cash flows are included in their income taxes paid disclosures and the amounts included.

5.7 Disclosures

Topic 235 requires an entity to disclose its significant accounting policies. Those are the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows or results of operations. This disclosure requirement encompasses those accounting principles and methods that, among other things, involve a selection from existing acceptable alternatives. [235-10-50-1, 50-3]

Therefore, we believe an entity should disclose its selected policy for accounting for nonrefundable, transferable tax credits – that is, whether the entity has elected to account for nonrefundable, transferable tax credits under Topic 740 or as government grants, inclusive of the election made for the classification of related cash flows in the statement of cash flows. If the entity elects to apply Topic 740, see section 4.3.30 for further discussion of required disclosures under that Topic. If the entity elects to account for the credits as government grants, then see section 3.8 for further discussion of government assistance disclosures required under Topic 832.

6. Tax equity structures: How they work and what accounting models apply**

Detailed contents

New chapter added in this edition (see Index of changes)**: ****

Examples

6.1 How tax equity structures work

A tax equity structure refers to a financial arrangement where investors (referred to as tax equity investors) provide capital to fund projects that will generate tax credits (e.g. renewable energy projects). This allows the developer of the project (referred to as the sponsor) to raise capital and the tax equity investor to receive a return primarily through tax benefits generated from the project.

A tax equity structure generally involves three parties – a pass-through entity, the sponsor and tax equity investors.

Pass-through entity

The pass-through entity, often structured as a partnership or limited liability company (LLC), serves as the legal owner of the project (e.g. wind or solar energy equipment). This structure allows the tax benefits generated from the project, such as tax credits or tax losses as a result of accelerated tax depreciation deductions, to flow through to the tax equity investor(s) and sponsor. See section 6.2 for accounting considerations related to the pass-through entity.

Sponsor

The sponsor is responsible for overseeing the development process of the project, including securing permits, acquiring land, designing and constructing the facility, and managing its operations. Sponsors typically have industry experience and serve as the general partner or managing member of the pass-through entity. See section 6.3 for accounting considerations related to sponsors.

Tax equity investors

Tax equity investors, typically large financial institutions or corporations, provide funding for the project but do not have operational control. Generally, tax equity investors seek to earn a return on their investment through a combination of:

- the tax credits and tax losses generated by the project; and
- positive cash flows generated from the project once it is in operation or upon exit.

Tax equity investors can benefit from these arrangements in the following manner:

- receiving the tax credits as an allocation from the pass-through entity, which are then used to reduce their income tax liability;
- receiving a distribution of the proceeds from the sale of the tax credits (in the case of transferable credits), which is exempt from taxation; or
- receiving a distribution of the proceeds received from the government (in the case of refundable credits), which is exempt from taxation.

See section 6.4 for accounting considerations related to tax equity investors.

Operating agreement

The pass-through entity, sponsor and tax equity investor(s) typically enter into an operating agreement that governs, among other things, how the pass-through entity's profits and losses, cash and tax benefits will be allocated among the sponsor and tax equity investor(s). Operating agreements often allocate these items disproportionately among the parties. For example, the allocation of tax benefits generated by the pass-through entity may be entirely different than the allocation of cash generated by the entity.

Partnership flip arrangement

A partnership flip arrangement is a specific type of tax equity structure whereby the tax equity investor receives the vast majority (e.g. 95% to 99%) of the losses/profits and tax benefits generated by the project up to a specified point in time, after which they 'flip' and the sponsor instead receives the vast majority of these items. Likewise, allocations of cash flows generated by the pass-through entity may also change at the 'flip date', albeit to a lesser extent (e.g. the tax equity investor may receive 25% of the cash distributions before the flip date and 5% thereafter).

The flip date may be based on the passage of time (e.g. five years) or the tax equity investor achieving a specified or target IRR on its investment. These structures also typically allow the sponsor to buyout the tax equity investor's equity interest after the tax equity investor has received a targeted return.

6.2 Accounting considerations: Pass-through entities

Partnerships or other pass-through entities (e.g. LLCs taxed as partnerships, subchapter S corporations) are not directly subject to income taxes in many tax jurisdictions. Whether part of a tax equity structure or not, 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 recognize 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 nonrefundable, transferable credits they generate from their operations.

Notwithstanding the fact that pass-through entities are not subject to income taxes, we believe such entities have the same accounting policy choices that are available to taxable entities for nonrefundable, transferable credits. Therefore, in preparing its separate financial statements, a pass-through entity can choose to account for nonrefundable, transferable credits as government grants or by applying Topic 740.

If the pass-through entity elects a government grant approach, it recognizes and measures the benefit of the credit in pretax income as further described in sections 3.1 and 5.3.20. The asset associated with a transferable credit is derecognized with an offsetting adjustment to equity when the credits are allocated to its owners.

However, if the pass-through entity applies Topic 740, we believe there should be no accounting recognition for nonrefundable, transferable credits prior to their sale. If the pass-through entity sells a transferable credit and receives cash, we believe the entity should recognize

- a liability when if it is obligated to distribute the proceeds to its owners; or
- equity when no such obligation exists.

We believe this accounting is appropriate because any tax credits generated by the pass-through entity are attributed to its owners and, therefore, it is as if the owner sold an asset and contributed the cash to the pass-through entity as a capital contribution. As such, we believe the pass-through entity should classify the cash proceeds from the sale of a transferable credit within financing activities in its statement of cash flows.

6.3 Accounting considerations: Sponsors

The sponsor in a tax equity structure generally consolidates the pass-through entity under Subtopic 810-10. Therefore, when preparing its consolidated financial statements, the sponsor must account for the tax equity investor's(s') equity interests in the pass-through entity as NCI. While Subtopic 810-10 requires entities to attribute a subsidiary's comprehensive income and net equity

between the parent and NCI, it provides little detailed guidance for this attribution.

Sponsors often use the HLBV method as the basis for attributing the pass-through entity's comprehensive income and net equity between their controlling interest and the tax equity investor's NCI. This is because the partnership agreement generally includes complex provisions for allocating profits and losses, liquidation proceeds and tax attributes. The HLBV method assumes that the net assets of the partnership are liquidated at their book values and distributed to the investors based on the distribution waterfall in the governing documents.

In applying the HLBV method, we understand there is diversity in practice on how a sponsor adjusts the NCI balance when it allocates ITCs to the tax equity investor(s). This is because ITCs may be subject to recapture if, for example, the partnership is liquidated before the credits fully vest under specified tax law. Recapture creates a tax liability for the investor that received the tax credits, generally the tax equity investor. Some governing documents explicitly require the sponsor to restore the tax equity investor's capital account if the ITCs are recaptured on liquidation of the partnership. Other agreements may guarantee the tax equity investor's IRR, but do not specifically address the sponsor's obligations on liquidation of the partnership and recapture of the ITCs.

Depending on the individual facts and circumstances, there may be a variety of acceptable methods that could be used to adjust the NCI balance when the sponsor allocates ITCs to the tax equity investor(s). However, we believe there are two primary methods.

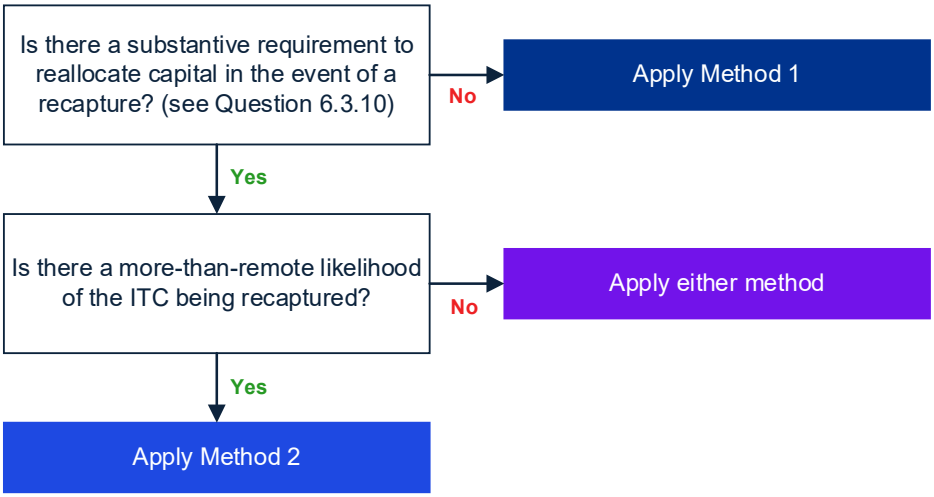
- **Method 1: Adjust NCI immediately on allocation of the ITCs**

  The sponsor immediately adjusts NCI upon allocating the ITC, which results in a corresponding increase to net income attributed to the controlling interest.

- **Method 2: Adjust NCI over the recapture period of the ITCs**

  Under Method 2, the sponsor adjusts NCI (and therefore recognizes the increase to net income attributed to the controlling interest) during the recapture period as the credits vest (and therefore are no longer subject to recapture). This results in an annual adjustment to NCI and net income attributed to the controlling interest through the date the recapture provision expires under tax law. Because recapture provisions generally lapse in a nonlinear fashion, the NCI adjustment is not expected to be ratable over quarterly reporting periods.

The selection of the appropriate method requires judgment and depends on the specific facts and circumstances. The diagram below illustrates how an entity may determine which method to apply:



When eligible for both methods, a sponsor's decision about whether to apply Method 1 or Method 2 is an accounting policy election that must be consistently applied to similar arrangements. See section 3.3 in KPMG Handbook, Accounting changes and error corrections, for guidance on voluntary changes in accounting policy.

As discussed above, we understand there is diversity in practice on this issue and there may be multiple acceptable approaches depending on individual facts and circumstances. However, we generally do not believe it is appropriate for the sponsor to adjust NCI over any of the following:

- 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 IRR.

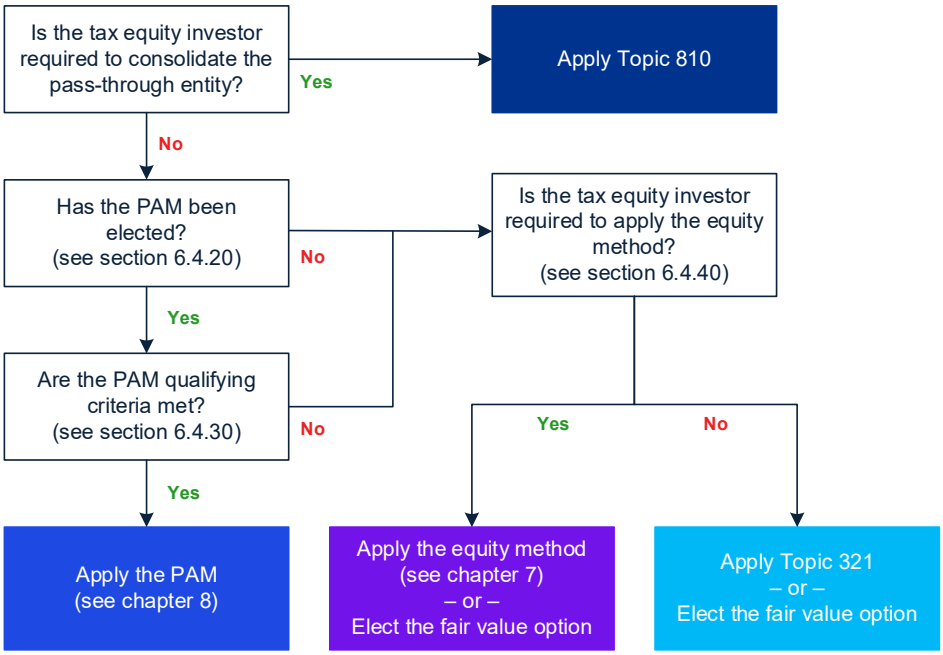
6.4 Accounting considerations: Tax equity investors

6.4.10 Overview

Depending on the specific facts and circumstances, a tax equity investor might account for its investment in the pass-through entity by:

- consolidating it under Topic 810;
- applying the equity method under Subtopic 323-30;
- applying the proportional amortization method (PAM) under Subtopic 323-740;
- accounting for it as an equity security under Topic 321; or
- electing the fair value option under Topic 825.

The following diagram illustrates how a tax equity investor determines which accounting model to apply.



The remainder of this section focuses specifically on the PAM and the equity method. For more information on applying Topic 810, see KPMG Handbook, Consolidation. For more information on applying Topic 321 and the fair value option, see KPMG Handbook, Investments.

6.4.20 Has the PAM been elected?

A tax equity investor must first decide whether to elect to apply the PAM. A tax equity investor may make this election because the PAM was specifically designed to better reflect the overall economics of investing in a tax equity investment. Under the PAM, the initial investment in the tax equity structure is amortized over the same period as, and in proportion to, the income tax benefits generated from the investment. This results in alignment of the recognition of the investment cost and the actual income tax benefits received.

The decision on whether to elect the PAM is made separately for each tax credit program – a tax equity investor can make the election for some tax credit programs and not for others. However, if the PAM is elected for a particular tax credit program, it must be applied to each tax equity investment that generates credits from that program (provided the PAM qualifying criteria are met (see section 6.4.30)). Said differently, while the PAM is elected on a tax credit program-by-program basis, it is applied on an investment-by-investment basis.

Further, a single tax equity investment may generate tax credits from multiple tax credit programs. In such cases, the determination of whether the PAM can be applied depends on the amount of tax credits that are received from those tax credit programs for which the investor has elected the PAM. For that reason, if a tax equity investor desires to use the PAM in all cases where it can be elected, it should elect the PAM for all tax credit programs from which it is

allocated tax credits by its tax equity investments. See Question 6.4.70 for how to apply the PAM qualifying criteria to a tax equity investment that generates tax credits from multiple tax credit programs.

Question 6.4.10
What is a tax credit program?

Interpretive response: For purposes of applying Subtopic 323-740, we believe tax credit programs should follow what the taxing authority defines as an individual tax credit under federal, state and local or foreign laws. That is, each separate type of tax credit generated by the pass-through entity is a 'tax credit program.' For examples of tax credit programs under the US federal tax law, see section 2.5.

Question 6.4.20
Which investments are eligible for the PAM?

Interpretive response: The PAM may be elected by tax equity investors in limited liability entities (e.g. partnerships, LLCs) that are pass-through (i.e. flow-through) entities for income tax purposes and generate income tax credits and other income tax benefits from a tax credit program. An investment is only eligible for the PAM if it was made with the primary purpose to receive income tax credits and other income tax benefits. In contrast, 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; and

Question 6.4.30
How does a tax equity investor account for a change in its PAM election?

Interpretive response: An investor that changes its PAM election for a tax credit program follows the guidance applicable to a change in accounting principle (see section 3.3 of KPMG Handbook, Accounting changes and error corrections).

6.4.30 Are the PAM qualifying criteria met?

If an investor has elected the PAM for a particular tax credit program, the next step is to evaluate the individual tax equity investment to determine if **all** of the PAM qualifying criteria are met. [323-740 Glossary, 323-740-25-1]

PAM qualifying criteria	
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 further discussion below.)
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 further discussion below.)
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 further discussion below.)
Limited liability criterion	One part of the limited liability criterion requires the investor to be a limited liability investor in the limited liability entity for both legal and tax purposes. The other part of the limited liability criterion requires that the investor's liability be limited to its capital investment. [323-740-25-1(c)] The investor fails the limited liability criterion when there is an enforceable agreement requiring a capital contribution to fund the tax equity investee's operating losses without limitation because the investor's liability is not limited to its capital investment in that situation.
	Source: Paragraph 323-740-25-1 of the Codification.

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 8.2.30, 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.

For detailed guidance on applying the PAM when all of the PAM qualifying criteria are met, see chapter 8.

Significant influence criterion

A tax equity investor is not permitted to apply the PAM if it concludes that it has significant influence over the operating and financial policies of the underlying project(s). Determining whether a tax equity investor has significant influence requires careful consideration of the facts and circumstances.

For purposes of assessing this criterion, the tax equity investor uses **qualitative** indicators of significant influence, including those in paragraphs 323-10-15-6 and 15-7. That is, we do not believe the presumptive quantitative thresholds based on ownership percentages (see section 6.4.40) are determinative when evaluating significant influence at the underlying project level. We believe this view is consistent with the EITF's discussion leading to the issuance of ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects, 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 underlying project's ongoing decision-making, including its operating and financial policies.

Therefore, a tax equity investor must understand and analyze its specific rights when evaluating its ability to exercise significant influence over the underlying project(s), including, but not limited to, its rights with respect to one or more of the following:

- the project's annual budget and significant changes to it;
- entering into (or making major modifications to) significant operations, maintenance or power purchase agreements for the project;
- pledging project assets as collateral in a loan agreement;
- selling significant project assets; and
- hiring management-level employees for the project.

We believe a primary consideration is whether the investor's rights are more akin to participating rights or protective rights. Analyzing an investor's rights as participating versus protective is an essential component of determining whether an investment in a partnership is consolidated (see section 5.3 of KPMG Handbook, Consolidation). Even though focused on consolidation, we believe a similar analysis should also be performed when determining whether an investor has significant influence over a project. We believe protective rights are less likely to result in the investor failing the significant influence criterion.

While the ownership percentage is not determinative or presumptive when evaluating significant influence at the project level, 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.

Substantially all and projected yield criteria

Both the substantially all and projected yield criteria are quantitative tests based on the tax equity investor's share of the total projected income tax credits and other income tax benefits (collectively, 'income tax benefits') to be generated over the term of its investment. However, there are two primary differences between these criteria – the benchmark that the projected income tax benefits are compared against and discounting.

PAM qualifying criterion	Benchmark	Discounting	When is it met
Substantially all	Total projected benefits of the tax equity investment (Total projected benefits are measured as the sum of the projected income tax benefits plus projected non-income-tax benefits, such as cash flows received from the pass-through entity's operations or proceeds received from the sale or disposition of the investment.)	Yes	When substantially all of the total projected benefits are from income tax benefits
Projected yield	Initial investment	No	When the projected income tax benefits are greater than the initial investment

While Subtopic 323-740 does not define 'substantially all', we believe it means 90%. This is consistent with how that term is interpreted in other US GAAP (e.g. Subtopic 842-10) and the EITF's deliberations leading to the issuance of ASU 2023-02, in which they acknowledged that 'substantially all' has generally been interpreted as 90% in practice.

For a projected income tax benefit to be included in the substantially all and projected yield criteria, we believe two conditions need to be met:

1. The tax equity investor will realize the benefit through a reduction of its cash taxes payable after evaluating recapture provisions, if any.
2. The benefit meets the recognition and measurement thresholds in accounting for income tax uncertainties under Topic 740.

Projected income tax benefits that do not meet both of these conditions are referred to as 'excluded income tax benefits'. See Question 6.4.80 for how a tax equity investor accounts for excluded income tax benefits.

Another critical element of estimating total projected income tax benefits is the period over which to make such projection. For example, consider a project that will provide tax benefits over a period of 10 years, but the investor plans to sell the related investment at the end of the fifth year. In this situation, we believe the investor should include the following in its application of the substantially all and projected yield criteria (as applicable):

- the total projected benefits and projected income tax benefits for the first five years; and
- the projected residual value of the investment at the end of the fifth year.

In practice, questions often arise as to whether certain benefits generated by the pass-through entity are considered income tax benefits and, therefore, included in the numerator of the substantially all and projected yield criteria. The table below summarizes these benefits and indicates whether they are considered income tax benefits.

Projected benefit	Included in projected income tax benefits?
Nonrefundable, nontransferable income tax credits [323-740-25-1(aaa)]	**Yes**
Nonrefundable, transferable income tax credits [323-740-25-1(aaa)]	**It depends** (see Question 6.4.40)
Refundable income tax credits (transferable or not) [323-740-25-1(aaa)]	**It depends** (see Question 6.4.50)
Other income tax benefits (e.g. the investor's share of taxable losses of the pass-through entity) [323-740-25-1(aaa)]	**Yes**
Cash flows from operations [323-740-25-1(aaa)]	**No**
Projected proceeds from the sale or disposition of the investment	**No**
Other transactions with the tax equity investee that do not meet certain conditions [323-740-05-1, 25-1B]	**No** (see Question 6.4.90)
Other non-income-tax related benefits	**No**

Example 6.4.10
Evaluating the substantially all criterion in 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.

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 and allocations 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%
Estimated residual investment	Nominal (none assumed 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 total project costs × 5%) ÷ 10 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.

For purposes of evaluating the substantially all criterion, Investor determines that a discount rate of 5% is consistent with its cash flow assumptions when it decided to invest in TEI. [323-740-25-1(aaa)]

Investor concludes that substantially all of the projected benefits of the underlying project in TEI are from income tax credits and other income tax benefits based on the following analysis.

		Undis-counted	Discounted
Income tax credits of $50,000 per year for the first four years, with the first allocation at the end of Year 1		200,000	177,297
Other income tax benefits from depreciation:			
Project costs	5,000,000		
Investor share of tax losses	× 5%		
Investor share of project tax losses	250,000		
Investor tax rate	× 25%		
Investor share of project tax losses received ratably over the 10 year depreciable life		62,500	48,261
Total income tax benefits		262,500	225,558
Non-income-tax-related cash returns of $500 per year for 10 years		5,000	3,861
Total benefits on a discounted basis			**229,419**
$225,558 ÷ $229,419 = 98%, which is substantially all			

Question 6.4.40

Are nonrefundable, transferable income tax credits considered income tax benefits when evaluating the PAM qualifying criteria?

Background: The application guidance for the substantially all criterion indicates that tax credits must be accounted for under Topic 740 to be considered income tax credits.

Interpretive response: We believe nonrefundable, transferable income tax credits should be included in income tax benefits when evaluating the PAM qualifying criteria only if they are accounted for under Topic 740 by the investor (see chapter 5) and only in either of the following circumstances:

- **Evidence exists to support that there is an agreement that requires the income tax credits to be allocated to the investor or sold with proceeds distributed to the investor.** This circumstance exists if the tax credits are allocated to the investor or if the tax credits are sold and the proceeds are distributed by the partnership to the investor. In this circumstance, we believe the investor controls the credit.
- **An enforceable agreement gives the investor the right to direct the sale of the income tax credits and receive the proceeds and provides for the income tax credits to be allocated to the investor if the investor does not direct their sale.** In this circumstance, we believe the benefits to be provided by the income tax credits belong to the investor because the tax equity investee is essentially acting as the investor's agent. In addition, the income tax credits are of no benefit to the partnership because the credits or the proceeds from selling them must be transferred to the investor. The benefits provided by the nonrefundable, transferable income tax credits in this circumstance are the same as if the investor generated the credit itself. While the nonrefundable, transferable income tax credit is considered an income tax benefit in this circumstance for purposes of the substantially all and projected yield criteria, the investor must consider whether the right it has to direct the sale of the credit causes it to fail the significant influence criterion (see section 6.4.20).

We believe other nonrefundable, transferable income tax credits should not be considered income tax benefits by the investor for purposes of determining whether the qualifying criteria have been met. However, they should still be included as part of the total projected benefits (i.e. the denominator) in applying the substantially all criterion.

Question 6.4.50

Are refundable income tax credits considered income tax benefits when evaluating the PAM qualifying criteria?

Background: The application guidance for the substantially all criterion indicates that tax credits must be accounted for under Topic 740 to be considered income tax credits.

Interpretive response: Generally, no. Refundable tax credits are accounted for as government grants and therefore are not in the scope of Topic 740 (see chapter 3).

However, a pass-through entity may agree, when the investors initially make their investment, to allocate the refundable tax credit to the investors at which point they become nonrefundable and nontransferable for the investor. In this situation, we believe the refundability of the tax credit should be evaluated at the level of a tax equity investor instead of at the pass-through entity level, if there is evidence to support the enforceability of the agreement between the entity and its investors to allocate the credits. We believe this results in the tax credit being

considered a nonrefundable, nontransferable tax credit for purposes of determining whether the credit is an income tax credit solely for evaluating the PAM qualifying criteria and applying the PAM. 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.

Excluding all other allocated refundable tax credits from the income tax benefits included in evaluating the substantially all criterion 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.

Question 6.4.60

Are income tax 'detriments' considered income tax benefits when evaluating the PAM qualifying criteria?

Background: In some cases, a tax equity investment may generate taxable income, which is then allocated to its investors. This allocated taxable income is considered an income tax detriment – it is a detriment to (i.e. offset of) the income tax benefits otherwise provided by the tax equity investment.

Interpretive response: No. When projecting the total income tax benefits expected from a tax equity investment for purposes of applying the substantially all and projected yield criteria, we believe the investor should exclude from the income tax benefits any expected income tax detriments.

Question 6.4.70

How are the substantially all and projected yield criteria applied to tax equity investments that generate income tax credits from multiple tax credit programs?

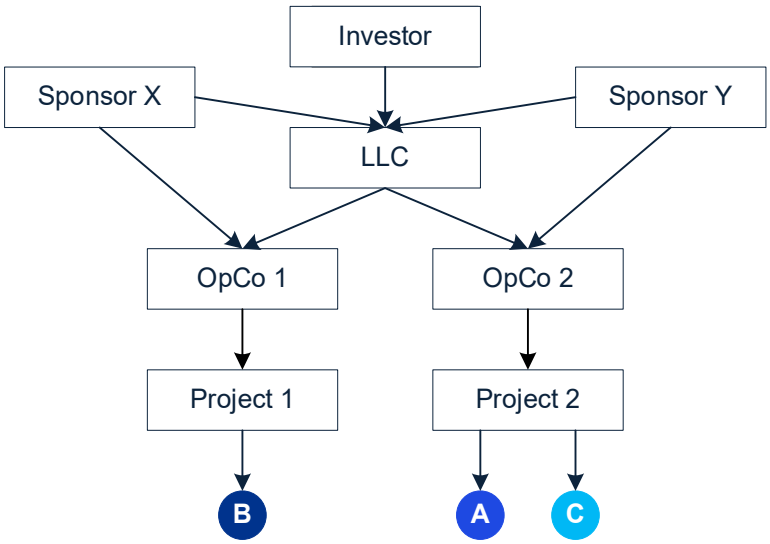
Background: As discussed in section 6.4.30, a tax equity investor could choose to apply the PAM for one tax credit program but choose not to for a different tax credit program. Further, a single tax equity investment could generate tax credits from multiple tax credit programs (e.g. when the pass-through entity owns multiple underlying projects).

Interpretive response: We believe that if more than 50% of the total projected income tax credits are from tax credit programs for which the investor has elected the PAM, then the numerator used in the substantially all criterion and the yield used in the projected yield criterion should include the income tax credits (and related other income tax benefits) generated by the tax equity investment from all income tax credit programs, regardless of whether or not the PAM has been elected.

Example 6.4.20 illustrates application of the substantially all criterion to a tax equity investment that receives tax credits from multiple tax credit programs and has elected the PAM for some, but not all, of the programs.

Example 6.4.20
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 to elect the PAM for Tax Credit Programs A and C, but not Tax Credit Program B.

The following are the tax credits (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

Step 1: First, Investor determines how much of the total projected income tax credits are from tax credit programs for which it has elected the PAM. In this case, Investor has elected the PAM for Tax Credit Programs A and C, which comprise 60% (($75,000 + $90,000) ÷ $275,000) of the total tax credits to be generated. Because this amount is greater than 50%, Investor includes the income tax credits generated from *all* programs when assessing the substantially all and projected yield criteria.

Step 2: Investor assesses whether the substantially all criterion is met. 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 93.8% (($75,000 + $24,000 + $110,000 + $36,000 + $90,000 +$28,000) ÷ $387,200) of the total projected benefits it expects to be allocated from LLC over the term of the investment are income tax benefits. Because 93.8% is substantially all, the substantially all criterion is met and Investor applies the PAM to account for its investment in LLC if the other PAM qualifying criteria are met.

Question 6.4.80

How does a tax equity investor account for excluded income tax benefits?

Background: A tax benefit may be excluded from the projected yield and substantially all criteria because it doesn't meet the recognition and measurement thresholds in Topic 740 or because the tax equity investor doesn't expect to realize the benefit. These tax benefits are referred to as 'excluded income tax benefits'. Additionally, excluded income tax benefits may arise in which an investor expects an income tax benefit in one period to be recaptured in a later period.

Interpretive response: Excluded income tax benefits should be excluded from both the income tax benefits and the total projected benefits used in evaluating the PAM qualifying criteria. We believe excluded income tax benefits 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 8.3); and
- any impairment analysis (see section 8.2.40).

Excluded income tax benefits are then accounted for like a 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.

For income tax benefits that are excluded because they are subject to recapture in a future year, we believe the investor should:

- recognize the reduction in its current tax liability in the period the investor reports the income tax benefit (consistent with its reporting on the tax return); and
- simultaneously establish a deferred tax liability for the future recapture of the income tax benefit.

Question 6.4.90

Are other transactions with the tax equity investee considered when evaluating the PAM qualifying criteria?

Interpretive response: There may be other transactions between the tax equity investor and the tax equity investee. For example, the tax equity 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 8.5). [323-740-25-1C]

6.4.40 Is the equity method required?

If the tax equity investor does not elect the PAM or does not meet all of the PAM qualifying criteria, it assesses whether it is required to account for its investment under the equity method (see chapter 7 for detailed guidance on applying the equity method to a tax equity investment).

If the reason the tax equity investor failed the PAM qualifying criteria is because it did not meet the significant influence criterion for the underlying project (that is, the tax equity investor concluded that it has significant influence over the operating and financial policies of the underlying project), then it applies the equity method (or fair value option) to account for its investment.

However, even if the tax equity investor concluded that it did not have significant influence over the underlying project(s) of the pass-through entity (see

'Significant influence criterion' in section 6.4.30), on the basis of qualitative indicators, it may still be required to apply the equity method to account for its investment. This is because paragraph 323-30-S99-1 indicates that an investor in a partnership or partnership-like LLC generally applies the equity method unless its interest is "so minor that it has virtually no influence." In addition, it states that the SEC staff considers investments of more than 3-5% to be more than minor. As such, investments of 3 to 5% (or more) in these entities are typically accounted for under the equity method. See KPMG Handbook, Equity method of accounting, for further information about the 'virtually no influence' threshold.

Subtopic 825-10 permits an investor to elect fair value measurement for an investment that would otherwise be accounted for under the equity method. However, Subtopic 825-10 requires an investor that has elected the fair value option for a would-be equity method investment to provide many of the disclosures required by Topic 323. This includes disclosing the investee's summarized financial information. For more information on accounting for would-be equity method investments under the fair value option, see KPMG Handbook, Equity method of accounting. [825-10-50-28(f), 323-10-50-3(c)]

Question 6.4.100

How does an investor account for ITCs under the deferral method when it elects the fair value option for a would-be equity method investment?

Interpretive response: If an investor elects the fair value option under Topic 825 for an investment in the scope of Topic 323 (equity method investments), we believe it should account for an ITC under the deferral method by:

- deferring the ITC benefit by recording a deferred income liability – not by reducing the carrying amount of its investment;
- recording deferred taxes associated with the deferred income liability immediately within income tax expense (benefit);
- recognizing the benefit of the ITC as a reduction of its income tax expense over the productive life of the underlying qualifying property giving rise to the tax credit; and
- computing and recognizing fair value measurement gains and losses associated with its investment independently of the ITC.

Example 6.4.30
Deferral method – Fair value option applied to tax equity investment

Background

ABC Corp operates in Country X and invests $65,000 for an ownership interest in Energy LLC, an alternative energy pass-through entity.

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 or transferred. Under the operating agreement, all the ITCs are allocated to ABC; however, there is a commensurate decrease in ABC's claim on the investee's net assets. The tax rate in Country X is 21%.

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, and they will be depreciated over that period for income tax purposes. Under the operating agreement, ABC is allocated 30% of Energy's operating income or loss, including depreciation.

Energy receives $100,000 of 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, which:

- 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.

Policy elections

ABC applies the deferral method to account for the ITC and accounts for its investment in Energy using the fair value option under Topic 825.

Journal entries

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	
Investment acquired:		*Recognize tax benefit of pass-through loss:*	
Dr Investment in Energy	65,000	Dr Income taxes payable[5]	1,260
Cr Cash	(65,000)	Cr Current tax benefit	(1,260)
Step 1, recognize deferred ITC:		*Step 3, recognize ITC benefit over productive life:*	
Dr Income taxes payable	50,000[1]	Dr Deferred income[6]	10,000
Cr Deferred income[2]	(50,000)	Cr Current tax benefit	(10,000)
Step 2, recognize deferred taxes related to the deferred ITC:		*Step 5, adjust deferred taxes:*	
Dr Deferred tax asset[3]	10,500	Dr Deferred tax asset[7]	5,040
Cr Deferred tax benefit[4]	(10,500)	Cr Deferred tax benefit	(5,040)
		Recognize fair value adjustment:	
		Dr Equity in losses	40,000
		Cr Investment in Energy	(40,000)

Notes:

1. $100,000 × 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 Question 6.4.100.
3. ($50,000 deferred income − $0 tax basis) × 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 Question 6.4.100).
5. $6,000 tax loss × 21% tax rate.
6. $50,000 deferred ITC benefit ÷ 5 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% × [($59,000 tax basis of investment ($65,000 initial basis − $6,000 tax loss for Year 1) − $25,000 book basis of investment ($65,000 initial basis − $40,000 fair value adjustment) + $40,000 ($40,000 book basis of deferred income – zero tax basis at December 31, Year 1)].

Effect on Year 1 financial statements ($)			
Assets		**Net income**	
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 to net income**	**(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)**		

7. Tax equity investments: Applying the equity method

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

7.1 How the standard works

While this chapter is written in the context of a tax equity structure, the guidance applies to any investment in a pass-through entity that generates tax credits accounted for under the equity method. Chapter 8 discusses the accounting when the PAM is elected and applied.

Tax credits generated by the pass-through entity

Neither Topic 323 nor Topic 740 specifically address how an investor accounts for the tax benefits received in the form of tax credits from an equity method investee. We believe the investor's accounting for such tax benefits ultimately depends on (1) the type of tax credits generated by the pass-through entity (i.e. ITC or otherwise), (2) the features of those tax credits (i.e. refundability and transferability), and (3) the investor's accounting policy(ies) for such credits assuming that it had generated them itself.

Features of the tax credit	Investor's accounting
Refundable	We generally believe an investor accounts for refundable tax credits generated by a pass-through entity as part of its overall equity method pickup consistent with all other items of income or loss reported in the pass-through entity's financial statements. However, other approaches may be acceptable. See section 7.3 for further discussion.
Nonrefundable, nontransferable	We believe an investor accounts for nonrefundable, nontransferable tax credits generated by a pass-through entity as a separate unit of account by applying Topic 740 as if the investor directly generated the credit. The accounting for the tax credits under Topic 740 depends on whether they are ITCs or another type of credit. The investor would then apply the equity method to recognize its share of the *other* items of income or loss reported in the pass-through entity's financial statements. See section 7.4 for further discussion.
Nonrefundable, transferable	We believe the investor's accounting depends on its policy election for nonrefundable, transferable credits. If the investor's policy is to account for such credits as government grants, then we believe it generally accounts for the credits in a manner consistent with the discussion above for refundable credits. That is, it accounts for the transferable tax credits as part of its overall equity method pickup consistent with all other items of income or loss reported in the pass-through entity's financial statements. However, other approaches may be acceptable. If the investor's policy is to account for such credits as income taxes under Topic 740, then we believe it accounts for the credits in a manner consistent with the discussion above for nonrefundable, nontransferable credits. That is, it

Features of the tax credit	Investor's accounting
	accounts for the transferable tax credit as a separate unit of account as if it directly generated the credit. To the extent that the investor's accounting policy for transferable credits is different from the pass-through entity's, it may need to recast the pass-through entity's financial statements when calculating its equity method pickup. See section 7.5 for further discussion.

7.2 Overview

The equity method generally requires the investor to: [323-10-30-2, 35-4]

- initially measure its investment at cost, including direct costs to acquire the interest; and
- recognize its share of the investee's profit or loss each reporting period, which is referred to as the 'equity method pickup'.

Given the complex capital allocation structures present in tax equity structures, a tax equity investor typically uses the HLBV method to measure its equity method pickup based on the guidance in the AICPA's Proposed SOP, Accounting for Investors' Interests in Unconsolidated Real Estate Investments (draft SOP). While the draft SOP was never finalized, an entity may find it helpful when evaluating whether its earnings allocation is consistent with the principles in Subtopic 970-323.

Under the HLBV method, an 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 operating 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 equity method pickup. This amount is recognized in 'equity in earnings (losses)' on the income statement 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 (i.e. basis differences) and elimination of certain intra-entity profits and losses.

Determining an investor's share of its investee's net assets may be complex, particularly in the context of tax equity structures. An investor analyzes the operating 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 operating 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 operating agreement.

See section 4.3 of KPMG Handbook, Equity method of accounting, for additional background on the application of HLBV.

7.3 Accounting for refundable credits generated by pass-through investees

When a tax equity structure generates refundable credits, the operating agreement may stipulate that the pass-through entity elect the direct pay option and distribute the cash to its investors. This is because (1) the direct pay option is only available to the pass-through entity as the legal owner of the credit and (2) choosing direct pay allows the pass-through entity to monetize the credit because it does not have an income tax liability to use the credit against.

As discussed in chapter 3, refundable credits are accounted for as government grants rather than as income taxes under Topic 740. However, US GAAP does not address how an investor accounts for the benefits received from an equity method investee in the form of refundable tax credits (government grants).

In the absence of such guidance, we believe an investor generally accounts for the benefits received from refundable credits generated by the pass-through entity as part of its overall equity method pickup consistent with its accounting for all other items of earnings and losses recognized in the pass-through entity's financial statements. However, other approaches may be acceptable.

If the cash proceeds from the refundable credits are distributed to the investor after the direct pay option has been elected, we believe it accounts for such distribution as a distribution received from an equity method investee under Topic 323. Therefore, it generally reduces the carrying amount of its investment in the pass-through entity by an amount equal to the distribution.

Temporary differences may arise under this approach – e.g. if the tax law only provides a partial reduction of the tax basis in the pass-through entity. In that case, an entity generally recognizes the related deferred taxes using the simultaneous equation approach (see section 3.2.30), but there may be other acceptable approaches.

7.4 Accounting for nonrefundable, nontransferable credits generated by pass-through investees

7.4.10 Overview

When a tax equity structure generates nonrefundable, nontransferable credits, the tax law will generally require the pass-through entity to allocate those tax credits to its investors. Therefore, nonrefundable, nontransferable tax credits generated by the project will automatically flow through to the investors, who can then claim them on their tax return to reduce their income tax liability.

As discussed in chapter 4, nonrefundable, nontransferable credits generated by an entity are accounted for as income taxes under Topic 740. However, Topic 740 does not address how investors account for nonrefundable, nontransferable credits that are generated by and received from a pass-through equity method investment.

We believe it is appropriate for an investor to account for such credits under Topic 740 as if it had generated the credits directly. As such, we believe there are effectively two units of account with respect to the investor's investment in the pass-through entity: (1) the nonrefundable, nontransferable tax credits, which are accounted for separately under Topic 740, and (2) the investment in the remaining net assets of the pass-through entity, which is accounted for under Topic 323, generally by using the HLBV method.

Nonrefundable, nontransferable tax credits: Applying Topic 740

In applying Topic 740 to the tax credits, the investor must determine whether the tax credits are ITCs or another type of tax credit (e.g. PTCs). If the tax credits are ITCs, we believe the investor should apply the same accounting policy that it applies to ITCs that it generates (i.e. the deferral method or flow-through method). If the investor does not generate ITCs from its own operations, we believe it should adopt an accounting policy and apply it consistently to all investments in pass-through entities that generate ITCs and to any ITCs it may directly generate in the future. See section 4.2.10 for further discussion of accounting policies available when accounting for an ITC.

Investment in remaining net assets: Applying Topic 323

In applying the HLBV method to its investment in the pass-through entity, an investor must account for changes to its claim on the net assets as a result of being allocated the tax credits. Specifically, when the pass-through entity allocates the tax credits to an investor, clauses in the operating agreement may cause that investor's claim on the investee's net assets to decrease. We believe an investor may account for this decrease under what we call a 'point in time approach' or a 'basis difference approach'.

Point-in-time approach

Under the point-in-time approach, when the investee reallocates its equity capital, the investor immediately recognizes a charge to equity in earnings (losses) equal to the decrease in its claim on the investee's net assets, consistent with its accounting for other changes to its share of the investee's net assets when applying HLBV.

We believe an investor generally uses this approach when (1) it receives ITCs from the pass-through entity and has an accounting policy to apply the flow-through method or (2) it receives tax credits other than ITCs, such as PTCs. This is because the immediate recognition of the income tax benefit from the tax credit will largely offset the immediate charge to equity in earnings (losses).

Section 7.4.20 describes how to apply the point-in-time approach in combination with the flow-through method.

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 – equal to the decrease in its claim on the investee's net assets. That basis difference is amortized to equity in earnings (losses) in the same periods that the investee depreciates the qualifying asset.

To quantify the decrease in its claim on the net assets of the investee (i.e. the basis difference), we believe the tax equity investor applies the HLBV method immediately after being allocated the ITC to determine its claim on the net assets of the investee. The difference between this amount and the tax equity investor's initial investment is the basis difference.

We believe an investor generally uses this approach when it receives ITCs from the pass-through entity and has an accounting policy to apply the deferral method. 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.

Section 7.4.30 describes how to apply the basis difference approach in combination with the deferral method.

7.4.20 Accounting for ITCs and other tax credits generated by pass-through investees under the flow-through method#

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 equity investor's claim on the investee's net assets).

Step 1: Immediately recognize the income tax benefit

An investor applying the flow-through method immediately recognizes the tax credit benefit in income tax expense (benefit) in the period the credit arises. When the tax credit arises, the investor's tax basis in the pass-through entity may decrease.

Step 2: Recognize deferred taxes on the temporary difference that arises with respect to the pass-through entity

A temporary difference arises to the extent that the investor's tax basis in the pass-through entity decreases (i.e. once the tax credit arises). If the tax credit is an ITC, we believe an investor may recognize the initial deferred tax effect of this temporary difference immediately in income tax expense (benefit) or by further adjusting the financial statement carrying amount of the investment. This adjustment to the financial statement carrying amount of the investment reverses as part of equity in earnings (losses) over the productive life of the asset.

If the investor elects to adjust the financial statement carrying amount of the investment, the amount of the temporary difference also changes and the calculation becomes circular. The investor solves for this circularity by using a 'simultaneous equation' (see section 4.2.30).

If the tax credit is not an ITC, we believe the initial deferred tax effects should be recognized immediately in income tax expense (benefit).

Step 3: Recognize the decrease in the investor's claim on the net assets of the pass-through entity
An investor applying the point-in-time approach recognizes the decrease to its claim on the net assets of the pass-through entity, if any, immediately in equity in earnings (losses).

Example 7.4.10
Flow-through method – Simple capital allocation structure

Background

Hydro LLC (Hydro) is a limited liability company treated as a partnership for income tax purposes. Hydro is generating hydropower in Country X. Country X provides a nonrefundable, nontransferable PTC equal to 20% of qualified hydropower production.

Tax Equity Investor, Inc. (TEI), an investor in Hydro and a profitable entity, is entitled to 80% of Hydro's income, gain, loss, deduction and tax credits. TEI accounts for its investment in Hydro using the equity method in accordance with Topic 323. Because Hydro does not have any special allocations, this example assumes there is no shift in TEI's claim on the net assets of Hydro as a result of allocating tax credits.

Other information

During Year 1, Hydro produces $50 million in qualifying hydropower energy and generates a PTC equal to 20%, or $10 million. As a pass-through entity for Country X income tax purposes, Hydro incurs no income tax liability. Assume Hydro's financial results for Year 1, as reported in its separate financial statements, are as follows.

Revenue	50,000,000
Cost of goods sold	(40,000,000)
Selling, general and administrative expenses	(5,000,000)
Other income	–
Net income	**5,000,000**

Journal entries

TEI records the following journal entries in Year 1 (for simplicity, the current taxes associated with its share of Hydro's earnings have been ignored).

	Debit	*Credit*
Deferred tax asset[1]	8,000,000	
Deferred tax benefit		8,000,000
To recognize TEI's share of the PTC generated by Hydro.		

	Debit	*Credit*
Investment in Hydro	4,000,000	
Equity in earnings		4,000,000
To recognize TEI's share of Hydro's earnings under the equity method.		

Note:

1. The PTC allocable to TEI (80% of the $10,000,000). Note no valuation allowance is necessary as TEI would be able to realize the deferred tax asset based solely on its profitability.

Example 7.4.20
Flow-through method – Complex capital allocation structure under HLBV

Background

Tax equity investor, Inc. (TEI) and Project Developer, Inc. (Developer) contribute $40 million and $60 million, respectively, to form Energy LLC (Energy), a pass-through entity, for the purpose of owning and operating an onshore wind farm in Country X. Energy will be entitled to a nonrefundable, nontransferable ITC equal to 30% of the cost of property (i.e. the onshore wind farm) once it is placed in service. Country X's income tax rate is 21%.

Energy is structured as a partnership flip, meaning that the allocation of its profits and losses, cash and tax benefits between TEI and Developer will change once the 'flip date' has been reached. The flip date is defined as the point in time that TEI achieves an IRR of 8% on its original investment (the Target IRR). TEI will achieve its Target IRR through a combination of cash distributions and allocations of the ITC and tax benefits from operating losses. The allocations of profits and losses, cash, and tax benefits are as follows.

	TEI		Developer	
	Pre-flip	Post-flip	Pre-flip	Post-flip
Profits, losses and tax benefits, including ITCs	99%	5%	1%	95%
Cash distributions	30%	5%	70%	95%

On January 1, Year 1, Energy purchases the onshore wind farm for $100 million and immediately places it in service. The wind farm will be depreciated on a straight-line basis over 10 years for financial reporting purposes and over five years for income tax purposes. Upon placing the wind farm into service, Energy immediately generates an ITC of $30 million (30% × $100 million purchase price), which it allocates to TEI and Developer according to their pre-flip allocation percentages.

Under the tax law in Country X, there is no limitation on the amount of the ITC that can be used in any given year. Further, upon generating the ITC, Energy's tax basis in the wind farm is decreased by an amount equal to 50% of the ITC, or $15 million ($30 million ITC × 50%). Similarly, TEI's tax basis in Energy will also decrease by its proportionate share of this amount based on its pre-flip allocation percentage (i.e. TEI's tax basis in Energy will decrease by $14.85 million [$15 million × TEI's pre-flip allocation percentage 99%] upon generation of the ITC).

In addition, the operating agreement for Energy specifies that upon liquidation, any liquidation gain (i.e. the excess of proceeds received over the pre-sale 704(b) capital account balances) will be allocated as follows (the 'liquidation waterfall'):

- first, to any investor that has a negative 704(b) capital account. The amount allocated and ultimately distributed to such investors will be the amount necessary to restore their capital account balance to zero;[4]
- second, to TEI until it achieves its Target IRR; and
- lastly, any excess gain to the investors according to their post-flip allocation percentages (and ultimately distributed).

Because Energy is a partnership-like LLC and TEI's investment is not 'so minor that it has virtually no influence' over Energy, TEI accounts for its investment under the equity method in Topic 323. Further, due to the complex allocation structure of Energy's profits, cash and tax benefits, TEI measures its equity method pickup using the HLBV method.

Policy elections

TEI has elected to account for ITCs using the flow-through method under Topic 740, and it has an income tax liability sufficient to use the entire amount of the ITC in Year 1. Additionally, TEI has a policy to recognize immediately in income tax expense (benefit) the initial deferred tax effect of any adjustment to the financial statement carrying amount of its investment in Energy and any adjustment to the tax basis in Energy that occurs when the tax credits are generated.

Measuring the equity method pickup

Energy's financial results under US GAAP and its taxable income for Year 1 are as follows.

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[4] A Section 704(b) capital account – or simply '704(b) capital account' – reflects a partner's economic interest in a partnership. It is increased by the partner's share of income or loss (which uses tax depreciation instead of book depreciation in this example) and is decreased by distributions paid to the partner. In addition, 704(b) capital accounts may be further adjusted for specific items, such as ITCs.

	US GAAP	Tax
Income before depreciation expense	1,000,000	1,000,000
Depreciation expense[1, 2]	10,000,000	17,000,000
Net loss	**(9,000,000)**	**(16,000,000)**

Notes:

1. Depreciation expense under US GAAP is equal to the financial statement carrying amount of the windfarm ($100,000,000) divided by its useful life of 10 years.
2. Depreciation expense under the tax law is equal to the tax basis of the wind farm assets of $85,000,000 ($100,000,000 purchase price, less reduction in tax basis of $15,000,000 from generating the ITC) divided by its tax depreciable life of 5 years.

TEI performs a series of calculations to measure its equity method pickup under the HLBV method at the end of Year 1 (which is the first reporting period for TEI). First, it determines the amount of the hypothetical gain that would be realized if Energy were to sell all of its assets and settle all of its liabilities at the US GAAP carrying amount at the end of Year 1, which is equal to the difference between Energy's book value and its 704(b) capital account balance.

	Book value	704(b) capital account	Hypothetical gain on liquidation
Beginning balance	–	–	
Contributions received	100,000,000	100,000,000	
Net loss	(9,000,000)	(16,000,000)	
ITC basis reduction	–	(15,000,000)	
Ending balance	**91,000,000**	**69,000,000**	**22,000,000**

Next, TEI determines its claim on the net assets of Energy upon liquidation, which is based on the terms of the liquidation waterfall specified in the operating agreement. Because both TEI and Developer have positive 704(b) capital account balances at the end of Year 1, the first step of the liquidation waterfall is not necessary. Therefore, TEI performs the second and third steps of the liquidation waterfall to determine the amount of gain that it would be allocated upon sale. It performs this calculation as follows:

Step 2 of the liquidation waterfall	
Total return necessary for TEI to achieve its Target IRR[1]	43,200,000
Less: Returns already provided to TEI	
ITC benefit[2]	(29,700,000)
Benefit from allocated tax losses[3]	(3,326,400)
Remaining return required for TEI to achieve its Target IRR	10,173,600

Step 2 of the liquidation waterfall	
TEI's pre-sale 704(b) capital account balance[4]	(9,310,000)
Allocation of gain to achieve Target IRR	**863,600**
Step 3 of the liquidation waterfall	
Remaining unallocated gain on liquidation[5]	21,136,400
TEI's post-flip allocation percentage	5%
TEI's allocation of remaining gain	**1,056,820**
Calculation of TEI'S total claim on energy's net assets	
TEI's pre-sale 704(b) capital account balance	9,310,000
Gain allocated under step 2 of the liquidation waterfall	863,600
Gain allocated under step 3 of the liquidation waterfall	1,056,820
TEI's total claim on Energy's net assets	**11,230,420**

Notes:

1. Amount is calculated as TEI's initial investment of $40,000,000, multiplied by 108%. In practice, the calculation of the IRR can be much more complex after considering the effects of time value of money and pretax versus after-tax returns.
2. Total ITC generated by Energy ($30,000,000) multiplied by TEI's pre-flip allocation percentage (99%).
3. Amount represents the benefit that was provided to TEI in the form of the tax loss generated by Energy during Year 1. The amount of tax loss allocated to TEI in Year 1 is $15,840,000 (Energy's total tax loss of $16,000,000 × TEI's pre-flip allocation percentage 99%) and the actual benefit realized by TEI from those losses is $3,326,400 ($15,840,000 × TEI's tax rate of 21%).
4. TEI's 704(b) pre-sale capital account at the end of Year 1 is equal to its initial contribution of $40,000,000, less (1) the reduction of $14,850,000, which occurred when the ITC was generated and (2) its share of Energy's taxable losses ($15,840,000).
5. Amount is equal to the total gain of $22,000,000, less the amount allocated to TEI under step 2 of the liquidation waterfall ($863,600).

TEI then calculates its equity method pickup under the HLBV method by computing the change in its claim on Energy's net assets from the beginning to the end of the reporting period, after adjusting for contributions and distributions.

Claim on Energy's net assets at the end of Year 1	11,230,420
Claim on Energy's net assets at the beginning of Year 1	–
Change in TEI's claim on Energy's net assets	11,230,420
Plus: Cash distributions received during Year 1	–
Less: Cash contributions made during Year 1	(40,000,000)
Equity method pickup	**(28,769,580)**

Journal entries

During Year 1, TEI records the following journal entries.

	Debit	*Credit*
Investment in Energy	40,000,000	
Cash		40,000,000
To record TEI's initial investment in Energy.		
Income taxes payable[1]	29,700,000	
Current tax benefit		29,700,000
To account for the ITC that was allocated to TEI from Energy.		

Note:

1. The amount of the ITC recognized is equal to the value of the credit ($30,000,000) multiplied by TEI's pre-flip allocation percentage (99%).

It recognizes the change in its claim on Energy's net assets by recording the following journal entry.

	Debit	*Credit*
Equity in earnings (losses)	28,769,580	
Investment in Energy		28,769,580
To record TEI's equity method pick up at the end of Year 1.		

As the final step, TEI accounts for the tax effects associated with its investment in Energy. The tax effects include (1) the benefit from Energy's tax losses that were allocated to TEI during the year and included on its tax return and (2) changes to deferred taxes related to its investment in Energy. TEI recognizes these amounts by recording the following journal entries.

	Debit	*Credit*
Income taxes payable	3,326,400	
Current tax benefit		3,326,400
To record TEI's benefit of operating losses.		
Deferred tax expense[1]	403,288	
Deferred tax liability		403,288
To account for the deferred taxes associated with the investment.		

Note:

1. At the end of Year 1, the financial statement carrying amount of TEI's investment in Energy is $11,230,420, which is greater than its tax basis in Energy of $9,310,000, resulting in a taxable temporary difference of $1,920,420. TEI records a deferred tax liability by multiplying the amount of the taxable temporary difference by its tax rate of 21%. Note that this reflects the amount of taxes that TEI would owe if Energy was liquidated at its book value at the end of Year 1.

7.4.30 Accounting for ITCs generated by pass-through investees under the deferral method

We believe there are five 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 equity investor's claim on the investee's net assets under Topic 323). 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 7.4.40 and illustrated in Example 7.4.30.

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			
Reduce carrying amount of asset (contra-asset)		Immediately in income tax expense (benefit)	
Step 3: Recognize the deferred ITC benefit over the productive life of the qualifying property			
Equity in earnings (losses)	Income tax expense (benefit)	Equity in earnings (losses)	Income tax expense (benefit)
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			

Step 1: Initially defer the ITC benefit

We believe a tax equity investor applying the deferral method initially records the ITC on its balance sheet by reducing the carrying amount of its equity method investment (the deferred ITC). 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.

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

We believe an investor may recognize the deferred tax effect related to the deferred ITC and any tax basis reduction immediately in income tax expense (benefit) or by further adjusting the financial statement carrying amount of the investment. This adjustment to the financial statement carrying amount of the investment reverses as part of equity in earnings (losses) over the productive life of the asset.

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 a 'simultaneous equation' (see section 4.2.30).

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

We believe an investor should recognize benefit from the ITC in its income statement over the productive life of the underlying qualifying property giving rise to the tax credit (the ITC benefit). An investor may present the ITC benefit in income tax expense (benefit) or in equity in earnings (losses) as a policy choice.

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.

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

An investor using the basis difference approach amortizes the basis difference over the productive life of the underlying qualifying property with a charge to equity in earnings (losses) and a credit to the investment.

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 related to the investment in the pass-through entity with a related adjustment to income tax expense (benefit).

Example 7.4.30#
Deferral method – Tax equity investor

Background

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 and unused credits can be carried over indefinitely but not refunded or transferred. Under the operating agreement, all

the ITCs are allocated to ABC; however, there is a commensurate decrease in ABC's claim on the investee's net assets. 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 operating 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.

Policy elections

ABC applies the deferral method to account for the ITC and the basis difference approach to account for the related decrease in its claim on the investee's net assets. The table below summarizes the other policy elections available under the deferral method.

Journal entries

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.

	Recognize deferred taxes as a contra-asset		Recognize deferred taxes immediately	
Outcome	**Recognize ITC benefit in equity in earnings**	**Recognize ITC benefit in income tax expense**	**Recognize ITC benefit in equity in earnings**	**Recognize ITC benefit in income tax expense**
Entries on Jan 1, Year 1				
Investment acquired:				
Dr Investment in Energy	65,000	65,000	65,000	65,000
Cr Cash	(65,000)	(65,000)	(65,000)	(65,000)

Outcome	Recognize deferred taxes as a contra-asset		Recognize deferred taxes immediately	
	Recognize ITC benefit in equity in earnings	Recognize ITC benefit in income tax expense	Recognize ITC benefit in equity in earnings	Recognize ITC benefit in income tax expense
Step 1, recognize deferred ITC:				
Dr Income taxes payable	50,000	50,000	50,000	50,000
Cr Investment in Energy	(50,000)	(50,000)	(50,000)	(50,000)
Step 2, recognize deferred taxes related to the deferred ITC:				
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)
Entries during Year 1				
Step 3, recognize ABC's share of investee's earnings and losses:				
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)
Step 3, recognize benefit of tax depreciation allocated to the tax equity investor:				
Dr Income taxes payable	1,260	1,260	1,260	1,260
Cr Current tax benefit	(1,260)	(1,260)	(1,260)	(1,260)
Step 3, recognize ITC benefit over the productive life of the underlying qualifying property:				
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)

Outcome	Recognize deferred taxes as a contra-asset		Recognize deferred taxes immediately	
	Recognize ITC benefit in equity in earnings	Recognize ITC benefit in income tax expense	Recognize ITC benefit in equity in earnings	Recognize ITC benefit in income tax expense
Step 4, recognize amortization of equity method basis difference:				
Dr Equity in losses	10,000	10,000	10,000	10,000
Cr Investment in Energy	(10,000)	(10,000)	(10,000)	(10,000)
Step 5, recognize change in deferred taxes[3]*:*				
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)
Liabilities				
Income taxes payable	(51,260)	(51,260)	(51,260)	(51,260)
Increase (decrease) in net assets	**(4,740)**	**(4,740)**	**5,760**	**5,760**
Net Income				
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) to net income	**(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:

1. 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, the deferred tax effect is calculated using the simultaneous equation.

2. 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 6.3.
3. 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.
4. The effective tax rate on equity in losses in Years 2 to 5 is the income tax benefit for the year of $1,260 plus $10,000 of reduction of the deferred ITC in two of the examples divided by ABC's annual equity in earnings (losses) which includes the $10,000 reduction of the deferred ITC in the other two examples (30% × ($100,000 equipment cost ÷ 5 years)).

Example 7.4.40**
Deferral method – Complex capital allocation structure under HLBV

Background

The same facts are used in this example as are used in Example 7.4.20. Also, assume the following additional facts.

- TEI has elected to account for the ITC using the deferral method under Topic 740 and to present the deferred ITC benefit in equity in earnings (losses). TEI expects to use the ITC to reduce its current year income tax liability and has elected to recognize the offsetting entry as an adjustment to income taxes payable.
- TEI has elected to use the basis difference approach to account for the decrease in its claim on Energy's net assets under Topic 323.
- TEI has elected to account for deferred taxes by further adjusting the financial statement carrying amount of the investment.

Measuring the equity method basis difference

As explained in section 7.4.10, under the basis difference approach, the tax equity investor identifies an equity method basis difference equal to the decrease in its claim on the investee's net assets upon being allocated an ITC. That basis difference is then amortized to equity in earnings (losses) in the same periods that the investee depreciates the qualifying asset. The following illustrates the computation of the equity method basis difference.

	Book value	704(b) capital account	Hypothetical gain on liquidation
Beginning balance	–	–	
Contributions received	100,000,000	100,000,000	
ITC basis reduction	–	(15,000,000)	
Ending balance	**100,000,000**	**85,000,000**	**15,000,000**

Determining TEI's claim on the net assets of Energy	
TEI capital account[1]	25,150,000
Distribution waterfall	
Step 1: Restore negative 704(b) capital account balances	–
Step 2: Allocate gain up to TEI's Target IRR[2]	–
Step 3: Allocate remaining gain to TEI based on its post-flip allocation %[3]	750,000
TEI's claim on Energy's net assets	25,900,000

Determining TEI's claim on the net assets of Energy	
TEI's initial investment	40,000,000
Equity method basis difference	**14,100,000**

Notes:

1. Amount is calculated as TEI's initial investment of $40,000,000, less its share of the ITC tax basis reduction of $14,850,000 [$15,000,000 × TEI's pre-flip allocation percentage of 99%].
2. TEI would receive total proceeds of $55,600,000 upon liquidation consisting of the ITC ($29,700,000) and the return of its 704(b) capital account ($25,150,000). Because this amount is greater than its Target IRR, no adjustment is necessary under Step 2 of the distribution waterfall.
3. Amount is equal to the total gain of $15,000,000 multiplied by TEI's post-flip allocation percentage (5%).

Measuring the equity method pickup

Under the basis difference approach, we believe the tax equity investor excludes changes to its claim on the net assets related to the allocation of the ITC when measuring its equity method pickup under the HLBV method. This is because that change is accounted for separately as an equity method basis difference, as explained above. Therefore, TEI's beginning claim on the net assets of Energy is effectively $25,900,000.

Journal entries

Upon investing in Energy and being allocated the ITC, TEI records the following journal entries.

	Debit	*Credit*
Investment in Energy	40,000,000	
Cash		40,000,000
To record TEI's initial investment in Energy.		
Income taxes payable[1]	29,700,000	
Investment in Energy		29,700,000
To initially defer the ITC benefit		
Deferred tax asset[2]	3,947,468	
Investment in Energy		3,947,468
To recognize deferred taxes related to the deferred ITC benefit.		

Notes:

1. The amount of the ITC recognized is equal to the value of the credit ($30,000,000) multiplied by TEI's pre-flip allocation percentage (99%).
2. Upon deferring the ITC benefit, the book basis of TEI's investment in Energy was decreased from $40,000,000 to $10,300,000. Likewise, its tax basis in Energy was decreased from $40,000,000 to $25,150,000 (its tax basis was reduced by 50% of its share of the ITC). Therefore, TEI had a deductible temporary difference of $14,850,000. Because it elected the policy to record deferred taxes by further adjusting the carrying amount of its investment in Energy, it uses the

simultaneous equation to measure the deferred tax asset related to this temporary difference [21% ÷ (1 – 21%) × $14,850,000].

During Year 1, TEI records the following journal entries.

	Debit	*Credit*
Investment in Energy[1]	2,970,000	
Equity in earnings (losses)		2,970,000
To recognize the deferred ITC benefit over the productive life of the underlying qualifying property		
Equity in earnings (losses)[2]	1,410,000	
Investment in Energy		1,410,000
To recognize amortization of the equity method basis difference		
Investment in Energy[3]	394,747	
Equity in earnings (losses)		394,747
To recognize amortization of the deferred tax adjustment to the carrying amount of the investment		
Equity in earnings (losses)[4]	14,669,580	
Investment in Energy		14,669,580
To record TEI's equity method pickup under the HLBV method		

Notes:

1. Amount is equal to the deferred ITC of $29,700,000 divided by the productive life of the underlying property (10 years).
2. Amount is equal to the equity method basis difference of $14,100,000 divided by the productive life of the underlying property (10 years).
3. Amount is equal to the adjustment to the carrying amount of the investment related to the simultaneous equation ($3,947,468) divided by the productive life of the underlying property (10 years).
4. Amount represents the difference between TEI's ending claim on the net assets of Energy ($11,230,420) and its beginning claim on the net assets ($25,900,000). See Example 7.4.20 for a detailed calculation of TEI's ending claim on the net assets of Energy.

For simplicity, this example ignores the tax effects associated with TEI's investment in Energy during Year 1.

Example 7.4.50
Deferral method – Leased property

Background

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. DEF is a pass-through entity and ABC accounts for its investment under the equity method. Both entities operate in Country X.

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 operating 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 or transferred. There is no decrease in ABC's claim on DEF's net assets as a result of being allocated the credit. The tax rate in Country X is 21%.

Policy elections

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

Other information

ABC will recognize taxable 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. ABC:

- needs no valuation allowance on its deferred tax assets; and
- expects to have taxable income and an overall income tax liability for all years.

Journal entries

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

Entries on Dec 31, Year 1	
Investment acquired:	
Dr Investment in DEF	65,000
Cr Cash	(65,000)

Entries on Dec 31, Year 1	
Step 1, recognize deferred ITC:	
Dr Income taxes payable[1]	50,000
Cr Investment in DEF	(50,000)
Step 2, recognize deferred taxes on investment in DEF:	
Dr Deferred tax asset[2]	10,500
Cr Deferred tax benefit	(10,500)
Recognize deferred taxes on income inclusion	
Dr Deferred tax expense	10,500
Cr Deferred tax liability[3]	(10,500)

Notes:

1. $100,000 qualifying investment × 50% ITC rate × 100% allocation percentage from DEF to ABC.
2. [$65,000 tax basis – ($65,000 initial investment in DEF − $50,000 deferred ITC)] × 21% tax rate.
3. $50,000 ITC × 100% (ABC's allocation from DEF) × 21% 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.

7.4.40 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.

Method	Presentation of ITC benefit	Recognition of initial deferred taxes	Outcome
Flow-through	N/A	Immediate	Full tax benefit of credit immediately recognized below pretax income, with an offsetting loss recorded above pretax income (related to the decrease in the investor's claim on the net assets of the investee, if any). The related deferred tax benefit is immediately recognized below pretax income.
Flow-through	N/A	Simultaneous equation	Full tax benefit of credit immediately recognized below pretax income, with an offsetting loss recorded above pretax income (related to the decrease in the investor's claim on the net assets of the investee, if any). The related deferred tax benefit is

Method	Presentation of ITC benefit	Recognition of initial deferred taxes	Outcome
			recognized as an adjustment to the carrying amount of the investment that reverses through pretax income over the productive life of the asset.
Deferral	Equity in earnings (losses)	Simultaneous equation	No tax benefit recognized when the credit arises. The ITC benefit and any reduction in the investor's claim on the net assets of the investee are both recorded above pretax income over the productive life of the related property and will offset one another. The related deferred tax benefit is recognized below pretax income over the productive life of the asset.
Deferral	Income tax expense (benefit)	Simultaneous equation	No tax benefit recognized when the credit arises. The ITC benefit is recognized over the productive life of the asset below pretax income, with an offsetting loss recorded above pretax income (related to any decrease in the investor's claim on the net assets of the investee). The related deferred tax benefit is recognized below pretax income over the productive life of the asset.
Deferral	Equity in earnings (losses)	Immediate	The ITC benefit and any reduction in the investor's claim on the net assets of the investee are both recorded above pretax income over the productive life of the related property and will offset one another. The related deferred tax benefit is immediately recognized below pretax income.
Deferral	Income tax expense (benefit)	Immediate	The ITC benefit is recognized over the productive life of the asset below pretax income, with an offsetting loss recorded above pretax income (related to any decrease in the investor's claim on the net assets of the investee). The related deferred tax benefit is immediately recognized below pretax income.

7.5 Accounting for nonrefundable, transferable credits generated by pass-through investees

Unless otherwise stated, all references to 'transferable credits' in this section means nonrefundable, transferable credits.

7.5.10 Overview

When a tax equity structure generates transferable credits, the operating agreement may (1) require the pass-through entity to either allocate the credits to its investors or sell the credits or (2) give the pass-through entity discretion on how to monetize the credits. If the operating agreement requires the pass-through entity to sell the credits or gives the entity discretion on how to monetize the credits, it may or may not require the entity to distribute the proceeds to its investors.

As discussed in chapter 5, entities have a policy choice to account for transferable credits as income taxes under Topic 740 or as government grants under an acceptable model (i.e. IAS 20, Subtopic 958-605, or Subtopic 450-30). However, like the discussion in section 7.3 on refundable credits and section 7.4 on nonrefundable, nontransferable credits, US GAAP does not address how to account for transferable credits that are generated by and/or received from a pass-through equity method investment.

We believe an investor should account for transferable credits generated by a pass-through equity method investee consistent with its accounting policy for transferable credits that it directly generates. If the investor does not generate transferable credits from its own operations, it should adopt an accounting policy to apply an income tax or government grant model (see chapter 5) and apply it consistently to all investments in pass-through entities that generate transferable credits.

7.5.20 Investor's accounting policy is to account for transferable credits as income taxes under Topic 740

If the investor's accounting policy is to apply Topic 740, then we believe it should account for transferable credits generated by a pass-through entity in a manner consistent with the discussion in section 7.4 on nonrefundable, nontransferable tax credits. That is, the investor would effectively account for its investment in the pass-through entity as two units of account: (1) the transferable tax credits, which are accounted for under Topic 740, and (2) its investment in the remaining net assets of the pass-through entity, which is accounted for under the equity method.

Accounting for transferable tax credits under Topic 740

In applying Topic 740 to the transferable tax credits, the investor determines whether the tax credits are ITCs or another type of tax credit (e.g. PTCs). If they

are ITCs, the investor applies the same accounting policy that it applies to (1) ITCs that it generates from its own operations or (2) nonrefundable, nontransferable ITCs that are generated by other investments in pass-through entities (see section 4.2.10 for further discussion of policy choices for ITCs under Topic 740). If the investor does not generate ITCs from its own operations and does not have investments in any other pass-through entities that generate ITCs, it should adopt an accounting policy and apply it consistently to all investments in pass-through entities that generate ITCs. In addition, in applying Topic 740, we believe an investor may either consider or disregard expected transfers of the credits in assessing their realizability as part of the valuation allowance analysis.

Accounting for remaining net assets under the equity method

In applying the equity method to the remaining net assets of the pass-through entity, the investor must account for changes in its claim on those net assets, if any, as a result of being allocated the tax credits. Specifically, when the pass-through entity allocates the tax credits to an investor, clauses in the operating agreement may cause that investor's claim on the investee's net assets to decrease.

If the pass-through entity has elected to account for the transferable credits as government grants in its separate financial statements (see section 7.6), we believe the investor must recast those financial statements when measuring its equity method pickup to avoid double counting the benefit from the tax credits. See section 7.5.40 for further discussion of when the investor and investee accounting policies for transferable credits differ.

7.5.30 Investor's accounting policy is to account for transferable credits as government grants

If an investor's accounting policy is to account for transferable credits as government grants, then we believe it generally accounts for transferable credits generated by a pass-through entity in a manner consistent with the discussion in section 7.3 on refundable tax credits generated by a pass-through entity. That is, the investor effectively accounts for its investment in the pass-through entity as a single unit of account under the equity method and includes the benefit from the transferable credits in its equity method pickup, consistent with its accounting for all other items of earnings and losses recognized in the pass-through entity's separate financial statements.

Further, if the pass-through entity has elected to account for the transferable credits under Topic 740 in its separate financial statements (see section 6.2), we believe the investor must recast those financial statements when measuring its equity method pickup to ensure the benefit from the tax credits is appropriately recognized in its financial statements. See section 7.5.40 for further discussion of when the investor and investee accounting policies for transferable credits differ.

However, other approaches may be acceptable (e.g. accounting for the transferable tax credits as a separate unit of account). Regardless of which approach is used, an investor must understand the pass-through entity's accounting policy for transferable credits to avoid double counting the benefit.

7.5.40 Accounting for differences between the investor's and investee's accounting policies for transferable credits

There may be situations where the investor's accounting policy for transferable credits differs from the pass-through entity's accounting policy. For example, the investor may account for such tax credits as government grants whereas the pass-through entity accounts for the credits under Topic 740 in its separate financial statements. Conversely, the investor may account for such tax credits under Topic 740 whereas the pass-through entity accounts for the credits as government grants in its separate financial statements.

In such situations, we believe the investor should account for the transferable credit based on its selected accounting policy, rather than the pass-through entity's selected accounting policy. Therefore, an investor may need to recast the separate financial statements of the pass-through entity when measuring its equity method pickup. As such, it is imperative that the investor obtain an understanding of the specific accounting policy selected by the pass-through entity and the amount of benefit from the transferable credit that was recognized in the pass-through entity's separate financial statements, if any.

The nature of the adjustment differs depending on which policies have been selected by the investor and the pass-through entity.

Investor policy	Topic 740	Pass-through entity policy	Government grant
Nature of the adjustment			
In this scenario, the investor accounts for the transferable credits as a separate unit of account (as if it generated the credit directly). As such, the investor would recognize the benefit of the transferable credit based on the nature of the tax credit (i.e. ITC or otherwise) and its accounting policy elections for nonrefundable, nontransferable tax credits (e.g. flow-through versus deferral method for ITCs). However, the pass-through entity would have also recognized the benefit of the transferable credit in its separate financial statements (in pretax income). Therefore, if the investor measured its equity method pickup based strictly on the pass-through entity's separate financial statements, it would double count the benefit of the tax credit. As double counting such benefit would be inappropriate, we believe the investor must ignore the benefit recognized in the pass-through entity's separate financial statements when recognizing its equity method pickup.			

Investor policy	Government grant	Pass-through entity policy	Topic 740

Nature of the adjustment

In this scenario, the investor generally accounts for the benefit of the transferable credits as part of its equity method pickup from the pass-through entity.

However, the pass-through entity would not have recognized any benefit from the transferable credit in its separate financial statements under Topic 740. Therefore, if the investor measured its equity method pickup based strictly on the pass-through entity's separate financial statements, it would never recognize the benefit of the tax credit.

We believe this outcome would be inappropriate as it would not be a faithful representation of the investor's financial position or performance. Further, the pass-through entity's accounting policy election to apply Topic 740 results in an outcome that would not be available to the investor if it had elected the same policy. That is, because the pass-through entity is nontaxable, it records zero benefit from the tax credit whereas if the investor, as a taxable entity, applies Topic 740 to the same credit, it would recognize the benefit within its financial statements.

As such, we believe the investor should recast the pass-through entity's financial statements when recognizing its equity method pickup to include the benefit from the tax credit.

In making this adjustment, the investor should follow its policy for government grants. For example, if the tax equity investor uses the grant model (i.e. by analogy to IAS 20), it should measure the amount of the benefit based on its expectations of whether the credit will be allocated to the investor or sold for cash. If the investor expects to be allocated the credit, we believe it should measure the benefit based on the full amount of the transferable credit. If the investor expects the credit to be sold, we believe it should measure the benefit at fair value or nominal value based on its chosen policy. If the actual method for monetizing the transferable credit differs from the investor's expectations, adjustments may be necessary in the investor's financial statements to reflect the actual benefit received from the transferable credits.

Example 7.5.10
Accounting for differences between investor and investee policies for transferable credits

Background

On January 1, Year 1 two investors, Project Developer, Inc. (Developer) and Tax equity investor, Inc. (TEI) form Hydro LLC (Hydro), a limited liability company treated as a partnership for income tax purposes. Hydro will operate a renewable energy project that generates hydropower in Country X. TEI accounts for its investment in Hydro using the equity method and is entitled to 80% of Hydro's income, gain, loss, deductions, and tax credits.

During Year 1, Hydro generates a nonrefundable, transferable PTC of $10,000 related to its hydropower energy production. Under the provisions of the tax law in Country X, Hydro may either (1) sell the PTC to a third party, or (2) allocate it to its investors at which point the PTC would be nonrefundable and

nontransferable to the investors. Hydro expects to sell the PTC and estimates it can be sold for 92% of the face value ($9,200).

Scenario 1: TEI applies Topic 740, Hydro applies IAS 20

During Year 1, Hydro's financial results are as follows under IAS 20.

Revenue	50,000
Cost of goods sold	(40,000)
Selling, general and administrative expenses	(5,000)
Other income	9,200
Net income	**14,200**

In applying Topic 740, TEI's policy is to consider the potential sale in assessing the realizability of the transferable PTC. Therefore, TEI records the following journal entry to recognize its share of the benefit from the PTC.

	Debit	*Credit*
Deferred tax asset[1]	8,000	
Valuation allowance		640
Deferred tax benefit[2]		7,360
To recognize TEI's share of the benefit from the PTC.		

Notes:

1. The PTC allocable to TEI (80% of the $10,000).
2. The benefit is based on TEI's share of the estimated amount that would be realized in a sale ($8,000 × 92%).

In measuring its share of Hydro's earnings and losses, TEI performs the following calculation to remove the PTC benefit:

Net income as reported in Hydro's separate financial statements	14,200
Remove benefit from the PTC recognized in Hydro's separate financial statements	(9,200)
Hydro net income, exclusive of PTC benefit	5,000
TEI share of Hydro's earnings and losses	80%
TEI equity method pickup	4,000

TEI records the following journal entry to record its share of the earnings and losses of Hydro under the equity method:

	Debit	*Credit*
Investment in Hydro	4,000	
Equity in earnings		4,000
To recognize TEI's equity method pickup related to Hydro.		

As a result of the above journal entries, TEI recognizes total income from its investment in Hydro equal to $11,360, which is equal to TEI's share of Hydro's total reported net income ($14,200 × 80%). Of this amount, $7,360 is recognized in TEI's income tax expense and $4,000 is recognized in TEI's equity method pickup.

Scenario 2: TEI applies IAS 20, Hydro applies Topic 740

During Year 1, Hydro's financial results are as follows under Topic 740.

Revenue	50,000
Cost of goods sold	(40,000)
Selling, general and administrative expenses	(5,000)
Other income	–
Net income	**5,000**

In measuring its share of Hydro's earnings and losses, TEI performs the following calculation.

Net income as reported in Hydro's separate financial statements	5,000
Add benefit from the PTC not recognized in Hydro's separate financial statements[1]	9,200
Hydro net income, inclusive of PTC benefit	14,200
TEI share of Hydro's earnings and losses	80%
TEI equity method pickup	11,360

Note:

1. Because Hydro expects to sell the PTC, TEI determines that the grant under IAS 20 is a nonmonetary asset. TEI's policy is to measure nonmonetary government grant assets at fair value, which it determines to be $9,200 (expected sale proceeds).

TEI records the following journal entry to record its share of the earnings and losses of Hydro under the equity method:

	Debit	*Credit*
Investment in Hydro	11,360	
Equity in earnings		11,360
To recognize TEI's equity method pickup related to Hydro.		

As a result of the above journal entries, TEI recognizes total income from its investment in Hydro equal to $11,360, which is the same as Scenario 1. However, this entire amount is recognized in TEI's equity method pickup, which is different from Scenario 1.

7.6 Impairment considerations

An investor must evaluate its investment in a tax equity structure for impairment, as necessary. For example, we believe a tax equity investor evaluates its tax credit investments accounted for under the equity method for impairment when there is a change in tax law (e.g. upon enactment of the OBBB) 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 impairment is deemed other-than-temporary, the investor reduces the carrying amount of the investment to its fair value by recognizing a charge in its income statement. The investor generally recognizes the impairment charge in the same line in which 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 8.2.40).

See section 5.5 of KPMG Handbook, Equity method of accounting, for additional background on impairment considerations for equity method investments.

7.7 Delayed equity contributions

As part of its initial investment, the tax equity investor may commit to future funding of an additional investment (i.e. make a delayed equity contribution). Under the equity method, delayed equity contributions generally are not recognized. Therefore, the tax equity investor does not recognize a liability for its commitment to future funding. This is different from how delayed equity contributions are accounted for under the PAM (see section 8.2.10).

8. Tax equity investments: Applying the PAM

Detailed contents

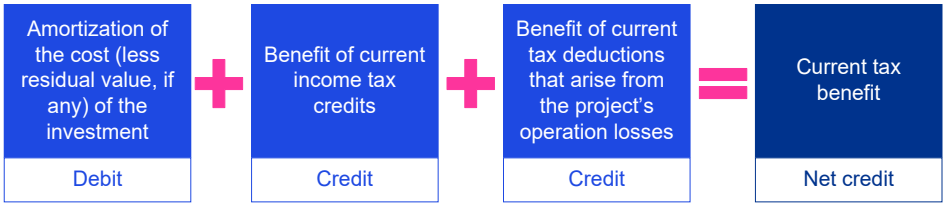
8.1 How the standard works

This chapter addresses the accounting for a tax equity structure when the PAM is elected and applied. For further information about electing and qualifying for the PAM, see section 6.4.

Under the PAM, a tax equity investor accounts for three key elements related to the tax equity structure: (1) its investment in the project, (2) the income tax benefits received from the investee, and (3) any non-income tax items received from the investee.

Investment in the project	The investor initially recognizes its investment in a tax equity structure at cost, which may include delayed equity contributions. It then amortizes the cost of that investment, less any expected residual value, in proportion to the income tax benefits it expects to receive from the project—typically tax credits and accelerated depreciation. This amortization is recorded as a component of income tax expense. See section 8.2 for further discussion related to accounting for the investment.
Income tax benefits (e.g. tax credits, share of the project's taxable income or loss, etc.)	The tax benefits received by the investor are recognized using the flow-through method, meaning they reduce the investor's income tax expense as the credits and deductions are earned. See section 8.3 for further discussion related to the accounting for income tax benefits generated from the project.
Non-income-tax items	Any non-income-tax-related returns from the investee—such as cash distributions or pre-tax income—are accounted for separately under the applicable GAAP guidance. These items do not influence the amortization calculation and are typically recognized in earnings as received. See section 8.4 for further discussion related to the accounting for non-income-tax benefits generated from the project.

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



8.2 Accounting for the investment

8.2.10 Initial recognition

A tax equity investor initially recognizes its investment in a tax equity structure at cost, which includes the amount paid by the investor to fund the project. Question 3.2.20 of KPMG Handbook, Equity method of accounting, discusses the accounting for direct costs incurred to acquire the investment. [323-740-35-2, 35-5]

As part of its initial investment, a tax equity investor may also commit to future funding of an additional investment (i.e. make a delayed equity contribution). A commitment for a delayed equity contribution is recognized as a liability, and an increase to the cost basis of the investment, if fulfilling it is (1) unconditional and legally binding or (2) contingent on a future event that is probable of occurring (i.e. 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. 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 Glossary, 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.

Question 8.2.10

Is the liability for a delayed equity contribution measured on a discounted or undiscounted basis?

Interpretive response: There is diversity in practice on whether the liability for a delayed equity contribution is measured on a discounted or undiscounted basis. We believe either measurement approach is acceptable.

When the liability is measured on an undiscounted basis, the corresponding increase to the cost basis of the investment is also measured on an undiscounted basis. We believe this measurement approach is consistent with not discounting income tax-related liabilities under Topic 740.

When the liability for a delayed equity contribution is measured on a discounted basis, the corresponding increase to the cost basis of the investment is also measured on a discounted basis. Under this measurement approach, we believe the accretion of the liability should be treated as interest expense. While measuring the liability on a discounted basis affects the amount initially recognized as an investment, it does not affect the subsequent measurement of the investment, which is at cost, net of amortization and any impairments.

Question 8.2.20

When is the probability of fulfilling a delayed equity contribution reevaluated?

Interpretive response: 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 8.5, 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 8.2.40).

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 Question 8.2.30). 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.

Question 8.2.30

How does an investor account for delayed equity contributions that are recognized after the initial investment date?

Interpretive response: When a delayed equity contribution is recognized after the tax equity investment's initial funding, the PAM qualifying criteria may need to be reevaluated to determine whether they are or continue to be met (see section 8.5. In addition, the investor considers whether an impairment analysis is necessary (see section 8.2.40).

If the PAM qualifying criteria 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 at that time into the PAM schedule for determining amortization of the investment. 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 8.2.10
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 6.4.20. 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 additional project costs × 5%) ÷ 9 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.

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 6.4.20. 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 × ($66,500 ÷ $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 × 5%) ÷ 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 × 5%) – $25,000) ÷ 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 × 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.

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:

A. 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).

B. 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 × ($10,250 ÷ $47,250) = $9,762.

C. The beginning net investment for the year (column A) less the amortization of the investment for the year (column B).

D. The incremental income tax credits allocated to Investor of $9,000 per year for Years 2-5.

E. Investor's share of the additional project costs related to the separate investment depreciated over the project's remaining useful life: ($900,000 × 5%) ÷ 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.

F. The tax effects of Investor's share of project tax losses (column E): $5,000 × 25% = $1,250.

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. There are no additional non-income-tax-related cash returns expected as a result of the separate investment.

Combination of separate and original investment schedules

The following table combines the amounts in the PAM schedule in Example 6.4.20 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		**300,000**		**236,000**	**295,000**	**73,750**	**309,750**	**9,750**	**5,000**

Question 8.2.40

Does a tax equity investor recognize deferred taxes related to its investment in a tax equity structure?

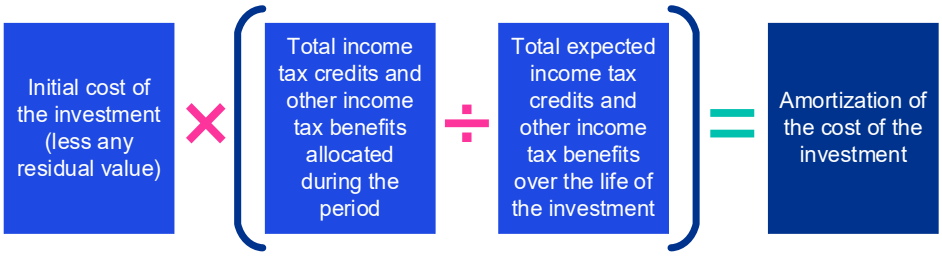
Interpretive response: No. We believe no deferred taxes should be recognized for the difference between the tax equity investment's book and tax basis because the book basis of the investment is amortized, in part, as the income tax benefits are allocated to the investor (i.e. there is book basis **assigned** 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 section 5.5). 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. [740-10-25-50 – 25-52, 45-22]

In addition, in certain circumstances, the tax basis of a tax equity investment may be subject to a statutory reduction when the tax credits are generated. For the reasons discussed above, when the PAM is applied to account for the tax equity investment, we believe deferred taxes should not be provided for the resulting temporary difference. However, in certain situations (Question 6.4.80), a deferred tax liability may be required for excess income tax benefits.

8.2.20 Amortizing the investment

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.



Practical expedient

As a practical expedient, an investor is allowed to amortize the initial cost of its investment in proportion to only the income tax credits allocated to it (as opposed to in proportion to all income tax benefits allocated to it). However, this practical expedient is only permitted 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]

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.

Example 8.2.20
Application of the PAM to a tax equity investment

This example is a continuation of Example 6.4.20. Investor evaluates the PAM qualifying criteria and determines that its investment in TEI satisfies those criteria.

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

	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 × ($56,250 ÷ $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 × 5%) ÷ 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 × 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.

Journal entries

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.

	Debit	*Credit*
Investment in TEI	255,000	
Cash		255,000
To recognize initial investment on January 1, Year 1.		
Income taxes payable	56,250	
Current tax benefit		1,607
Investment in TEI		54,643
To recognize the income tax credits allocated to Investor in Year 1 and the effects of applying the PAM.		
Cash	500	
Pretax earnings[1]		500
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).		

Note:

1. The cash returns from the underlying project's operations are often recognized in 'Other income/expense'.

Practical expedient application

Question 8.2.50

How does an investor evaluate whether the practical expedient produces a result that is 'substantially similar' to the PAM?

Interpretive response: When an investor is evaluating the substantial similarity between the measurements from applying the PAM and the practical expedient, we believe it may use the net effect of each on income tax expense. 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]

Question 8.2.60

How does an investor account for deferred taxes if it applies the practical expedient?

Interpretive response: 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 Question 8.2.40).

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 8.2.30

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
Investor's tax rate	40%

Investor	
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 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.

Year	A Beginning net investment	B Amortization of investment	C Ending net investment	D Income tax credits	E Investor share of project tax losses	F Other income tax benefits from tax losses	G Income tax credits and other income tax benefits	H Total current tax benefit (expense)	I Tax basis of investment	J Deductible temporary difference	K Deferred tax asset	L Deferred tax benefit (expense)	M Total tax benefit (expense)	N 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 × ($8,000 ÷ $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 × 5%) ÷ 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 × 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 × 40% = $2,909.

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 × 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.

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

8.2.30 Changes in estimates under the PAM

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 6.4.30); 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 8.2.10).

Changes in estimates are generally 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.

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). Consideration should also be given

to whether a change in estimate warrants evaluating the investment for impairment (see section 8.2.40).

While changes in estimates are generally recognized prospectively, we believe that when a change in estimate is caused by a change in tax law, 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.

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 8.2.40).

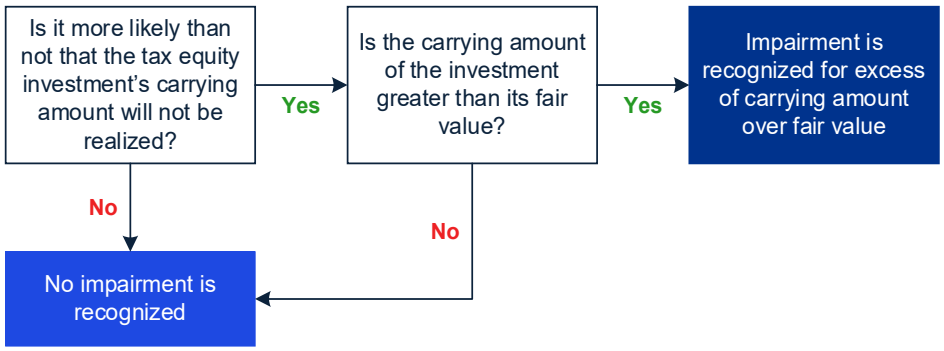
Prospective

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 8.2.40 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.

8.2.40 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. Subtopic 323-740 does not address whether to discount cash flows when making this determination, but we believe undiscounted cash flows should be used. [323-740-35-6]

If the investor concludes the carrying amount of a tax equity investment is not more likely than not to be realized using undiscounted cash flows, an impairment loss is recognized for the excess of the investment's carrying amount over its fair value measured in accordance with Topic 820 (fair value measurements). A discounted cash flow method could be used to measure the fair value of the investment. [323-740-35-6]

Once recognized, an impairment loss cannot be reversed. [323-740-35-6]

Question 8.2.70

How does an investor evaluate the realizability of tax equity investments under the PAM?

Interpretive response: 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. Cash flows from operations or the anticipated proceeds from the sale or disposition of the investment may also be considered.

However, if positive cash flows from operations or disposition are necessary to realize the investment's carrying amount (i.e. expected income tax benefits alone are not sufficient), the PAM qualifying criteria are unlikely to be met on an ongoing basis. Therefore, the investor cannot continue to apply the PAM. 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 and,

therefore, one of the PAM qualifying criteria (the projected yield criterion) would no longer be met.

8.3 Accounting for income tax benefits generated by the investment

An investor must use the flow-through method to recognize income tax credits and other income tax benefits 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 amortizing the initial cost of the investment based on the income tax credits and other income tax benefits **allocated** to the investor. Section 4.2 provides additional discussion about the flow-through method. [323-740-35-2]

Question 8.3.10

How does an investor account for allocated income tax credits that it cannot realize on its current-year tax return?

Background: In many circumstances, allocation of an income tax credit to the investor and its inclusion in the tax return occurs 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 income tax credits or other income tax 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.

Interpretive response: The effects 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 tax benefit in calculating the amortization of the investment.
- **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, consider whether the need for a valuation allowance results in:

- the remaining investment being impaired (see section 8.2.40); and/or
- the PAM qualifying criteria no longer being met (e.g. the projected yield has changed from positive to negative) (see section 8.5).

8.4 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.

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]

8.5 Reevaluation circumstances

When the PAM has been elected for the tax credit program from which a tax equity investment generates tax credits, an investor reevaluates whether the PAM qualifying criteria are met upon the occurrence of one or both of the following from paragraph 323-740-25-1C. [323-740-25-1C]

"a. A change in the nature of the investment (for example, if the investment is no longer in a flow-through entity for tax purposes)"; or

"b. A change in the relationship with the underlying project that could result in the reporting entity no longer meeting the conditions in paragraphs 323-740-25-1 through 25-1B."

While change (b) specifically references the reevaluation only resulting in the investor 'no longer meeting' the PAM qualifying criteria, change (a) does not limit its consideration to only those circumstances where the criteria were initially met. Therefore, in situations where the PAM has been elected for the tax credit program but the qualifying criteria were not initially met, we believe the investor reevaluates the criteria when there has been a change in the nature of the investment (see Example 8.5.10). Determining whether such a change has occurred requires judgment and consideration of the facts and circumstances.

We believe the changes (or triggers) that cause a reevaluation of the PAM qualifying criteria should also result in the reevaluation of whether a tax equity investment falls in the scope of Subtopic 323-740 (see Question 6.4.20). 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.

If any one of the PAM qualifying criteria are no longer met upon reevaluation, the investor discontinues applying the PAM (see section 8.6). If the PAM qualifying criteria are first met upon reevaluation, we believe the investor

transitions to the PAM on a prospective basis. For purposes of the PAM amortization schedule, the carrying amount of the investment is treated as the initial investment.

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
There is a change in the agreement with the tax equity investee that provides the investor with additional rights and obligations related to the investee's underlying projects.	
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 income 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.[1]	
A change occurs in the agreement with the tax equity investee that results in the investor losing the ability to direct the sale of a transferable credit and receive the cash proceeds.	
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.	Limited liability criterion
The investor is no longer a limited liability investor in a limited liability entity for both legal and tax purposes.	

Note:

1. In some cases, tax equity investors are required to make delayed equity contributions on a 'pay as you go' (PAYGO) basis. For example, an investor may be required to make a PAYGO contribution based on the amount of tax credits generated, which may be based on another variable, such as the amount of wind-generated power produced by the tax equity investee. PAYGO payments are regularly required payments contingent upon actual production. If the entity initially qualified to apply the PAM, we do not believe a reevaluation would be triggered when the PAYGO contribution is made because we do not believe the contribution represents either a change in the nature of the investment or a change in the relationship with the tax equity investee's underlying projects.

Question 8.5.10

What information does an investor consider when reevaluating the PAM qualifying criteria?

Interpretive response: When reevaluating the substantially all and projected yield criteria (see section 6.4.30), we believe the investor should consider the full term of the investment and not just the remaining term. In other words, 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. In addition, if a delayed equity contribution becomes probable and estimable after the initial investment, we believe the reevaluation should reflect both the initial investment and the probable and estimable delayed equity contribution. Example 8.5.10 illustrates an investor's consideration of the full term of the investment when reevaluating the substantially all and projected yield criteria.

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.

Example 8.5.10

Reevaluation of PAM qualifying criteria when not initially met due to unknown future investments and benefits

Investor invests in Tax Equity Investment (TEI) on November 1, Year 1. The investment is in the scope of Subtopic 323-740 (i.e. it is a tax equity investment), and Investor has elected the PAM for the relevant tax credit programs.

The terms of the investment require a nominal initial investment from Investor on November 1, Year 1 and entitle Investor to income tax benefits (i.e. income tax credits and other income tax benefits) in an amount that is less than the initial investment. While additional investments may be made in the future, the timing and amount of those investments, as well as the amount of income tax benefits to be received in return, will not be estimable until a future date.

Investor concludes the future additional investments are not probable of occurring based on the facts and circumstances as of November 1, Year 1. As such, Investor does not include them or the related income tax benefits when assessing the PAM qualifying criteria on that date and therefore the investment does not meet the substantially all or projected yield criteria. Investor does not apply the PAM to the initial investment in LLC and instead accounts for the investment under other applicable US GAAP.

Reevaluation

On September 30, Year 2, the timing and amount of the additional investments as well as the amount of income tax benefits to be received are probable and estimable.

Because the qualifying criteria were not met initially, Investor reevaluates whether the PAM qualifying criteria are met as of September 30, Year 2. This is because the nature of the investment changes when the timing and amount of the future additional investments and income tax benefits become probable and estimable, which satisfies paragraph 323-740-25-1C(a).

Investor also reevaluates the PAM qualifying criteria based on the full term of the investment and not just the remaining term. Therefore, when evaluating the PAM qualifying criteria, Investor includes:

- the initial investment at November 1, Year 1;
- the actual income tax benefits allocated to it through September 30, Year 2; and
- the projected income tax benefits that became probable and estimable at September 30, Year 2.

Only income tax benefits generated after September 30, Year 2 are considered when applying the PAM accounting model and the September 30, Year 2 carrying amount is treated as the initial investment.

Change in tax law

Question 8.5.20

Does an investor reevaluate the PAM if a tax law change may affect the PAM qualifying criteria?

Interpretive response: Yes. When there is a change in tax law (e.g. OBBB) 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. When the PAM qualifying criteria continue to be met, the investor next assesses the investment for impairment by determining whether it is more likely than not that the investment is not realizable (see section 8.2.40).

8.6 Discontinuing application of the PAM

As discussed in section 8.5, an investor reevaluates in certain circumstances whether the PAM qualifying criteria are met for a tax equity investment. In

addition, as discussed in section 8.2.40, 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 other applicable US GAAP (see chapter 6). Additionally, deferred taxes are recognized through income tax expense for any temporary differences associated with the investment.

8.7 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 considering only 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 Question 8.2.40).

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. In addition, deferred taxes are recognized for the investment as necessary (see section 6 of KPMG Handbook, Accounting for income taxes).

8.8 Presentation and disclosure

8.8.10 Presentation

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, investors generally should classify such investments like other investments in the scope of Topic 323. [ASU 2014-01.BC17]

The net effect of applying the PAM to account for a tax equity investment is included within income tax expense/benefit in the income statement. The net

effect is presented as a current or deferred tax benefit (as appropriate) made up of the recognized amounts of investment amortization, income tax credits and other income tax benefits flowing from the tax equity investee.

Question 8.8.10

How does an investor present a delayed equity contribution liability in its balance sheet?

Interpretive response: We believe a delayed equity contribution liability should be presented as an other liability (current or noncurrent would depend on the timing of the expected contribution) and not debt. For significant delayed equity contribution liabilities, we believe the line item on the balance sheet in which they are included should be disclosed.

Question 8.8.20

How does an investor present an impairment charge related to a tax equity investment?

Interpretive response: An impairment charge that is not related to a change in tax law is presented as a pretax loss. However, when an impairment is due solely to a change in tax law (e.g. OBBB), we believe that an investor generally would present the impairment charge with the other effects of the change in tax law – i.e. in income tax expense (benefit) from continuing operations.

8.8.20 Disclosure

A disclosure objective and certain disclosure requirements apply to all tax equity investments generating tax credits from 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 when the PAM is elected

- For tax equity investments accounted for using the equity method, the amount of investment income or loss included in pretax income.
- Information about commitments or contingent commitments, including the amount of delayed equity contributions (see sections 7.7 and 8.2.40), 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 8.2.40), 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 8.2.20, 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 8.8.10, 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.

Rate reconciliation under the PAM

Because no deferred taxes are recognized under the PAM, 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. For additional information about this reconciliation, see paragraph 9.086 in KPMG Handbook, Accounting for income taxes, and KPMG Hot Topic, Income tax disclosures.

Example 8.8.10
Disclosure of tax equity investment

The same facts are used in this example as are used in Example 8.2.20. 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 its investment in TEI.

> The balance of our tax equity investment in TEI at the end of Year 1 is $200,357 and is included in the 'Investments' line item on the balance

sheet. 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.

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New sections, Questions and Examples added in this edition are identified throughout the Handbook with ** and those items that have been significantly updated or revised are identified with #.

8. Tax equity investments: Applying the PAM

This chapter was chapter 7 in the prior edition and has been substantially reorganized in this edition, including some content moving to new chapter 6. The reorganized content that remains in this chapter has not been marked at moved.

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