No. 2023-03
27 April 2023

Technical Line

FASB — final guidance

Expanded use of the proportional amortization method for equity investments in tax credit programs

In this issue:

Overview 1
Key considerations 2
Changes to conditions to be eligible to use the proportional amortization method 2
Other considerations for entities that applied the legacy guidance 4
Applying the proportional amortization method 4
Disclosures 6
Effective date and transition 7
Retrospective approach 7
Modified retrospective approach 7
Other transition considerations................ 7
Effective date 8

What you need to know

- The FASB issued final guidance allowing entities to apply the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740, rather than just investments in qualified affordable housing projects that generate low-income housing tax credits, as was required under the legacy guidance.
- The proportional amortization method allows entities to amortize the cost of the equity investment in proportion to the income tax credits and other income tax benefits received and to present the amortization expense and the income tax benefits on a net basis in income tax expense/benefit in the income statement.
- The guidance allows entities to elect the proportional amortization method on a tax-credit-program by tax-credit-program basis, and the method should be applied consistently to all investments in the tax credit program.
- The guidance is effective for public business entities for fiscal years beginning after 15 December 2023, and interim periods within those fiscal years and for all other entities for fiscal years beginning after 15 December 2024, and interim periods within those fiscal years. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) amended[1] Accounting Standards Codification (ASC) 323, *Investments — Equity Method and Joint Ventures*, to expand the use of the proportional amortization method to equity investments in all tax credit programs that meet the conditions in ASC 323-740-25-1, including the New Market Tax Credit (NMTC) program, the Historic Rehabilitation Tax Credit program and Renewable Energy Tax Credit programs.

Building a better working world

Previously, entities were permitted to apply the proportional amortization method only to investments in qualified affordable housing projects that generated low-income housing tax credits (LIHTC) and met the conditions in ASC 323-740-25-1.

The amendments, which are based on a consensus reached by the FASB's Emerging Issues Task Force (EITF or Task Force), also modified the conditions in ASC 323-740-25-1 that need to be met to apply the proportional amortization method. Entities with investments in tax equity structures that were not in the scope of the legacy guidance should evaluate these investments to determine whether the investments meet the conditions to use the proportional amortization method and whether they want to elect to apply the method to eligible investments.

Entities that have existing investments in LIHTC programs need to evaluate the changes the FASB made to the conditions for using the proportional amortization method and other changes that will affect investments in LIHTC programs accounted for using the equity method or cost method.

For more information on the legacy guidance on proportional amortization, refer to section 4.2.8.7, of our Financial Reporting Developments publication, *Income Taxes*.

Key considerations

Substantially all of the projected benefits must be from income tax credits and other income tax benefits in order to apply the proportional amortization method.

Under the proportional amortization method, the equity investment is amortized in proportion to the income tax credits and other income tax benefits received, with the amortization expense and the income tax benefits presented on a net basis in income tax expense or benefit on the income statement. The decision to apply the proportional amortization method is an accounting policy election that is made on a tax-credit-program-by-tax-credit program basis and should be applied consistently to all investments in an elected tax credit program that meet the conditions in ASC 323-740-25-1.

The proportional amortization method may only be applied to equity investments made through limited liability entities that are flow-through entities for tax purposes (e.g., a limited liability partnership or a limited liability company). The method cannot be applied to investments in tax credit structures the investor is required to consolidate. In addition, the election would not apply to investments in tax credit structures that are classified as debt.

Changes to conditions to be eligible to use the proportional amortization method

The amended guidance allows investors to elect to use the proportional amortization method to account for equity investments in income tax credit programs through limited liability entities if the following conditions are met:

- It is probable that the income tax credits allocable to the investor will be available. (ASC 323-740-25-1(a))
- The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project. (ASC 323-740-25-1(aa))
- Substantially all of the projected benefits are from income tax credits and other income tax benefits. This condition is determined on a discounted basis. (ASC 323-740-25-1(aaa))
- The investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive. (ASC 323-740-25-1(b))
- The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment. (ASC 323-740-25-1(c))

The amended guidance under condition ASC 323-740-25-1(aa) requires that an investor determine it does not have the ability to exercise significant influence over the operating and financial policies of the underlying project, rather than the limited liability entity through which it receives tax benefits as was required under the legacy guidance.

The Task Force said this change was needed to address multitiered structures that may exist in tax credit programs (e.g., NMTC tax structures). In multitiered structures, there are several flow-through entities between the tax equity investor and the project itself, and without this amendment it was unclear which entity in the structure should be the focus of the evaluation. The Task Force also wanted to eliminate opportunities to structure a project to achieve a desired result (i.e., structuring opportunities).[2]

Projected benefits under ASC 323-740-25-1(aaa) include all the benefits that will be received from the equity investment, including income tax credits, other income tax benefits (e.g., the investor's share of tax benefits from the operating losses of the project) and non-income-tax-related benefits. The amended guidance clarifies that when determining whether substantially all of the projected benefits are from income tax credits and other income tax benefits, an entity includes tax credits accounted for outside of ASC 740[3] (e.g., refundable tax credits or other non-income-based credits) in the total projected benefits (denominator) but not in the amount of income tax credits and other income tax benefits (numerator).

The amended guidance also requires an entity to use discounted amounts when assessing whether ASC 323-740-25-1(aaa) is met (i.e., substantially all of the projected benefits are from income tax credits and other income tax benefits). The discount rate selected should be consistent with the cash flow assumptions used by the investor for purposes of making a decision to invest in the project. The legacy guidance does not address whether the projected benefits should be based on a discounted basis when assessing this condition.

Consistent with legacy guidance, the amended guidance in ASC 323-740-25-1(b) requires the investor's projected yield based solely on the cash flows from the income tax credits and other income tax benefits to be positive. This assessment requires an entity to make sure the income tax credits and other income tax benefits provides a positive yield when compared to its initial equity investment. When an entity determines the initial equity investment to include in this assessment, we believe the entity should use an amount consistent with the initial measurement in accordance with ASC 323-10-30-2, using a cost accumulation model in which the investment is recognized based on the cost to the investor. This cost is generally based on the fair value of the consideration paid, including transaction costs.

The eligibility conditions in ASC 323-740-25-1 are assessed at the time of the initial investment. A reporting entity is required to reevaluate the conditions if there is a change in the nature of the investment or in the relationship with the underlying project that could result in the conditions no longer being satisfied. For example, this may occur when a project no longer qualifies for the income tax credits or the investor determines it might not realize some or all the expected income tax benefits.

Entities with existing investments in LIHTC programs that are accounted for using the proportional amortization method will need to consider the changes to the conditions in the legacy guidance when adopting the amendments (i.e., determine whether they will still qualify to use the proportional amortization method).

How we see it

ASC 323-740-25-1(aaa) does not address whether a quantitative threshold needs to be met to satisfy the "substantially all" condition. We generally believe an entity has met this threshold in ASC 323-740-25-1(aaa) when 90% or more of the projected benefits of the tax equity investment results from income tax credits or other income tax benefits. The Task Force indicated that it did not intend to change practice regarding the application of the "substantially all" condition.[4]

The proportional amortization method allows for amortization of the investment to be recognized as a component of income tax expense or benefit.

Other considerations for entities that applied the legacy guidance

The amendments eliminate certain guidance on the accounting for investments in LIHTC programs to align it with the accounting for investments in other types of tax credit equity investment structures. The amendments will affect investments in LIHTC programs that were accounted for under the legacy proportional amortization guidance, as well as investments accounted for under the legacy guidance using the equity method or cost method.

Entities applying the legacy equity or cost method guidance to their investments in LIHTC programs will need to consider the following amendments which:

- No longer permit the use of the cost method to account for equity investments in income tax credit structures (including LIHTC structures) but require entities that do not either qualify or elect to use the proportional amortization method and do not qualify for the use of the equity method to apply the guidance in ASC 321, *Investments — Equity Securities*
- Eliminate an alternative method to measure impairments for investments accounted for using the equity method in ASC 323-740-55-8 through ASC 323-740-55-9 and require entities to apply the impairment guidance in ASC 323 to their income tax credit investments accounted for under the equity method
- No longer permit entities with investments in LIHTC structures that did not use the proportional amortization method (e.g., those that applied the equity method or cost method) to use the delayed equity contribution guidance in ASC 323-740-25-3 and now will require entities to apply the delayed equity contribution guidance if they account for the investment (including LIHTC investments) using the proportional amortization method

Applying the proportional amortization method

Under the proportional amortization method, the amortization of the investment is calculated by multiplying:

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

The amortization of the investment is recognized in the income statement as a component of income tax expense or benefit, which results in the net presentation of the amortization of the investment, income tax credits and other income tax benefits. Non-income tax-related benefits received from operations of the investment should be included in pretax earnings when realized or realizable. Gains or losses on the sale of the investment, if any, should be included in pretax earnings at the time of sale.

ASC 323-740-35-4 provides for a practical expedient to amortize the investment in proportion to only the income tax credits allocated to the investor (i.e., other income tax benefits are not included in the calculation) if the investor reasonably expects that doing so would produce a measurement that is substantially similar to the measurement that would result from the inclusion of other income tax benefits in the calculation.

Under the proportional amortization method, an investment must be tested for impairment when events or changes in circumstances indicate that it is more likely than not that the carrying amount of the investment will not be realized. An impairment loss is measured as the amount by which the carrying amount of the investment exceeds its fair value.

The amendments require entities to apply the flow-through method to investments in tax credit structures that qualify and are accounted for using the proportional amortization method. That is, entities that use the proportional amortization method will no longer have the option

to apply the deferral method under ASC 740.[5] Entities that have applied the deferral method to existing tax equity structures (LIHTC and other than LIHTC tax structures) and elect to use the proportional amortization method will need to change to the flow-through method.

The following illustration shows how the proportional amortization method would be applied by an investor that has elected to apply the method and has met the conditions in ASC 323-740-25-1. It is based on the illustration in ASC 323-740-55-11 through ASC 323-740-55-15:

Illustration: Application of the proportional amortization method

Facts:

- The investor contributed $102,000 at the beginning of the first year of eligibility for the income tax credit.
- Depreciation expense is computed, for book and tax purposes, using the straight-line method with a 10-year life.
- The investor's tax rate is 40%.
- The partnership will receive income tax credits from a tax credit program. The income tax credits will be received over a four-year period.
- The investor will receive cash proceeds based on a fixed percentage of the project's cash generated during the life of the project (i.e., non-income-tax-related cash returns).
- After 10 years, the investor has a right to require that the project sponsor purchase the investor's equity interest for a nominal amount. It is assumed that the option will be exercised. This amount is assumed to be zero for simplicity, resulting in a residual value of the investment of zero.

The following table shows the calculation of the amounts recognized each period as a component of income tax expense and the non-income tax related benefits that are required to be presented on a pre-tax basis:

Year	Net Investment[(a)]	Amortization of Investment[(b)]	Income Tax Credits[(c)]	Net Losses/Tax Depreciation[(d)]	Other Income Tax Benefits from Tax Depreciation[(e)]	Income Tax Credits and Other Income Tax Benefits[(f)]	Income Tax Credits and Other Income Tax Benefits, Net of Amortization[(g)]	Non-Income Tax-Related Cash Returns[(h)]
1	$ 81,600	$ 20,400	$ 20,000	$ 10,000	$ 4,000	$ 24,000	$ 3,600	$ 200
2	61,200	20,400	20,000	10,000	4,000	24,000	3,600	200
3	40,800	20,400	20,000	10,000	4,000	24,000	3,600	200
4	20,400	20,400	20,000	10,000	4,000	24,000	3,600	200
5	17,000	3,400	-	10,000	4,000	4,000	600	200
6	13,600	3,400	-	10,000	4,000	4,000	600	200
7	10,200	3,400	-	10,000	4,000	4,000	600	200
8	6,800	3,400	-	10,000	4,000	4,000	600	200
9	3,400	3,400	-	10,000	4,000	4,000	600	200
10	-	3,400	-	10,000	4,000	4,000	600	200
Total		$ 102,000	$ 80,000	$ 100,000	$ 40,000	$ 120,000	$ 18,000	$ 2,000

(a) End-of-year carrying amount of the investment net of amortization in Column (b).

(b) Initial investment of $102,000 x (total income tax credits and other income tax benefits received during the year in Column (f)/ total anticipated income tax credits and other income tax benefits over the life of the investment of $120,000).

(c) Represents the income tax credits allocated to the investor.

(d) Income tax losses, principally from depreciation, passed on to the investor

(e) Column (d) x 40% tax rate.

(f) Column (c) + Column (e).

(g) Column (f) − Column (b).

(h) Non-income-tax-related benefits recognized in current-period pretax earnings when received. This represents the cash proceeds received by the investor based on the cash generated from the project.

Based on the schedule above, the investor will recognize an annual income tax benefit of $3,600 in years 1-4 of the investment (comprising of gross income tax benefit of $24,000 less the amortization of the initial investment $20,400) and $600 in years 5-10. The non-income tax-related benefits would be included in pretax income.

Disclosures

The amendments require entities to make disclosures about all investments in a tax credit program(s) that they have elected to account for using the proportional amortization method, including those investments in an elected tax credit program(s) that do not meet the conditions to use the proportional amortization method.

For example, an entity may have multiple investments in tax equity structures that generate tax credits under a tax program for which it has elected to use the proportional amortization method, but not all investments meet the conditions to use the proportional amortization method (i.e., they are accounted for using the equity method or ASC 321). The disclosure requirements in ASC 323-740-50 would apply to all investments in the tax credit program, regardless of whether the proportional amortization method is applied to the individual investment.

ASC 323-740-50-1 requires an entity to disclose the following:

- The nature of its investments
- The effect of the recognition and measurement of its investments and the related income tax credits and other income tax benefits on its financial position and results of operations

Disclosures required by ASC 323-740 apply to all investments in tax credit programs for which the entity has elected to apply the proportional amortization method.

ASC 323-740-50-1A requires the following additional disclosures to meet the objectives in ASC 323-740-50-1:

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

Additionally, ASC 323-740-50-2 states that an entity may consider disclosing the following:

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

Entities should also consider whether additional disclosures are required for investments in tax credit programs where the entity elected to apply the proportional amortization method, but the investments did not meet the eligibility conditions required to apply ASC 323-740 and accounted for them using other US GAAP (i.e., ASC 321 and ASC 323).

Effective date and transition

Entities may apply the guidance on a retrospective or modified retrospective basis. In addition, entities that hold investments in LIHTC programs are flow-through entities for tax purposes and need to make changes to their accounting because they are no longer permitted to apply (1) the cost method, (2) the impairment guidance included in the legacy example in ASC 323-740-55-8 through ASC 323-740-55-9 or (3) the delayed equity contribution guidance may do so using a prospective approach. Entities that elect to apply these specific amendments prospectively are still required to apply all other amendments on a retrospective or modified retrospective basis, if applicable.

For both the retrospective and modified retrospective approaches, an entity that elects to apply the proportional amortization method should determine whether the investment qualifies for the proportional amortization method as of the date that investment was originally entered into and considering any modifications (including those that would require the reassessment in ASC 323-740-25-1C).

Retrospective approach

An entity applying a retrospective approach should identify all investments in tax credit structures that are still expected to generate either income tax credits or other income tax benefits as of the beginning of the earliest comparative period presented. To make this determination, the entity should use the actual tax credits and other income tax benefits received and the remaining benefits expected to be received as of the beginning of the earliest period presented. For those identified investments, the entity will need to determine whether those tax credit investments qualify for the proportional amortization method as of the date the investment was originally made. An entity should record a cumulative-effect adjustment to the opening balance of retained earnings in the earliest period presented for the difference caused by applying the amended guidance.

Modified retrospective approach

An entity applying a modified retrospective approach should identify all investments in tax credit structures that are still expected to generate income tax credits or other income tax benefits as of the adoption date. To make that determination, the entity should use the actual tax credits and other income tax benefits received and the remaining benefits expected to be received from a tax credit investment as of the adoption date. For those identified investments, the entity will need to determine whether those tax credit investments would qualify for the proportional amortization method as of the date the investment was originally made. An entity would record a cumulative effect adjustment to the opening balance of retained earnings at the beginning of the fiscal year of adoption for the difference caused by applying the amended guidance.

Other transition considerations

Entities electing to use the proportional amortization method for investments in tax credit structures and that did not apply the legacy delayed equity contribution guidance will need to include both the actual equity contributions made and the expected equity contributions to be made in accordance with ASC 323-740-25-3.

Entities that have investments in LIHTC programs that are not accounted for using the proportional amortization method and are no longer permitted to use (1) the cost method, (2) the alternative equity method impairment guidance in ASC 323-740-55-8 through ASC 323-740-55-9 or (3) the delayed equity contribution guidance, may apply the guidance by using either (1) the modified retrospective or retrospective methods or (2) a prospective transition method (as of the beginning of the fiscal year of adoption).

If a prospective approach is applied, a cumulative effect adjustment as a result of applying the new guidance would be recognized as an adjustment to current-period earnings, the balance sheet or both on the date of adoption. An entity may individually select a transition method for each of the three adjustment types (i.e., the cost method, the alternative equity method impairment guidance and the delayed equity contribution guidance), and the transition method selected should be applied consistently for that adjustment type.

An entity that has investments in LIHTC programs that are not accounted for using the proportional amortization method in ASC 323-740 should do the following in the period of adoption:

- If the delayed equity contribution method was used, the entity should derecognize any liability related to delayed equity contributions and adjust the corresponding LIHTC investment and other accounts as necessary.
- If the cost method was used, the entity should make necessary changes to account for the investment in accordance with ASC 321.
- If the alternative impairment method was used, the entity should make necessary changes to account for the investment in accordance with the impairment guidance in ASC 323.

An entity is required to provide the transition disclosures in ASC 250-10-50-1 through 50-2 upon adoption.

Effective date

The guidance is effective for public business entities for fiscal years beginning after 15 December 2023, and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2024, and interim periods within those fiscal years.

Early adoption is permitted for all entities, including early adoption in any interim period. If an entity adopts the amendments in an interim period, it needs to adopt them as of the beginning of the fiscal year that includes that interim period.

Endnotes:

---

[1] Accounting Standards Update (ASU) 2023-02, *Investments — Equity Method and Joint Ventures, (Topic 323): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method.*

[2] BC17 from ASU 2023-02.

[3] ASC 740, *Income Taxes.*

[4] BC19 from ASU 2023-02.

[5] BC20 from ASU 2023-02.

EY | Building a better working world

© 2023 Ernst & Young LLP.
All Rights Reserved.

SCORE No. 19482-231US

ey.com/en_us/assurance/accountinglink

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via **ey.com/privacy**. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit **ey.com**.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.