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FASB Announces New Simplified Financial Accounting Rules for Qualified Investors in Low-Income Housing Tax Credit (LIHTC) Projects

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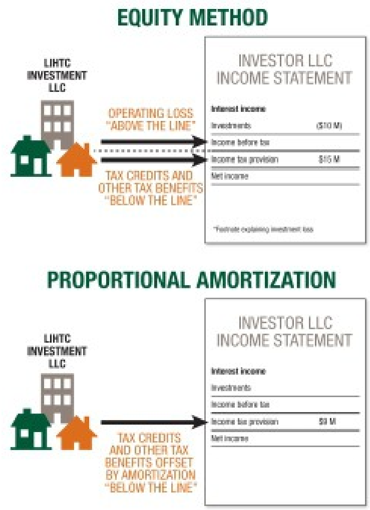
The Financial Accounting Standards Board (FASB) has announced new simplified financial accounting rules for qualified investors in Low-Income Housing Tax Credit (LIHTC) projects. The rule change will make it easier for investors to opt out of the Equity Method of accounting for LIHTC investments and instead use the new Proportional Amortization Method. The main benefit is improved clarity and simplicity in financial reporting: passed through losses from a LIHTC investment will appear on the investor's income statement "below the line" along with the LIHTC and other tax items. In addition, the new method also provides for a relatively simple amortization calculation. Previously, those few investors who were able to opt for below-the-line loss reporting had relatively complicated calculations to do under the Effective Yield Method.

Improved Appearance on Financial Reports

The Equity Method requires investors to account separately for their share of passed-through operating losses from the LIHTC investment entity and their allocated LIHTC. An Equity Method investor records the LIHTC investment as an asset. Then, as net operating income or losses occur in the LIHTC investment entity, the investor's share of the income or loss from the investment increases or decreases the book value of the investor's asset. Because LIHTC projects typically operate at a net loss, the Equity Method investor will almost always report a net loss on its income statement (an "above the line" loss). This gives the appearance of a bad investment. The tax credits are reported separately as a component of the income tax costs of the investor (a "below the line" benefit). The fact that the loss was expected and that overall the investment has a positive impact on the income statement is then typically explained in one or more footnotes.

Investors using the Proportional Amortization Method will not record operating losses from the LIHTC investment entity on the income statement. Instead, investors will amortize the LIHTC



investment, recording the amortization as a component of the investor's income tax cost (or benefit) along with the LIHTC. Therefore, when the investment performs as expected, the annual result from the LIHTC investment will be reported as a below-the-line, after-tax benefit on the income statement. This method of reporting corresponds better to the economics of the LIHTC investment, since the tax credits are the dominant reason for the investment and the operating losses are incidental.

Simplified Amortization

The Proportional Amortization Method simplifies the investor's reporting as compared to the Effective Yield Method, which prior to the rule change was the alternative to the Equity Method. The Effective Yield Method allowed investors to report losses "below the line," but its amortization method was complicated, requiring investors to get financial data from the investment entity.

The new Proportional Amortization Method allows the investor to amortize its initial LIHTC investment according to the percentage of tax benefits allocated to the investor in the current period divided by the total tax benefits that the investor expects to receive over the life of the investment. Because the tax credits generally are predictable and do not change over the life of the investment, for most investors the Proportional Amortization Method will result in relatively level amortization over time.

It should be noted that the Proportional Amortization Method also reduces the incentive for investors to get out of LIHTC projects after the tax credit period. Under this new method, investment amortization and tax credit reporting will be coterminous. Previously, after the tax credit period, investors were incentivized to sell out because of continued losses (because most investors used the Equity Method, these were usually above-the-line operating losses) with no offsetting tax credits.

To qualify for the Proportional Amortization Method, an investor must meet the following conditions:

- It is probable that the tax credits allocable to the investor will be available;

- The investor does not have the ability to exercise significant influence over the operating and financial policies of the investment entity;
- Substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits attributable to the operating losses of the investment);
- The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive;
- The investment entity is a limited liability entity; and
- The investor is a limited liability investor in the investment entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.

FASB Rule Update No. 2014-01 can be found on the FASB website.

For additional information regarding tax credits, please contact your usual Goulston & Storrs attorney or any of the attorneys in Goulston & Storrs' Tax Credits group:

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