

# FASB changes accounting for tax credit investments

US2023-02

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## At a glance

In March 2023, the FASB issued [ASU 2023-02, Investments - Equity Method and Joint Ventures \(Topic 323\): Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method \(a consensus of the Emerging Issues Task Force\)](#). [ASU 2023-02](#) expands the use of the proportional amortization method of accounting — currently allowed only for investments in low-income housing tax credit (LIHTC) structures — to equity investments in other tax credit structures that meet certain criteria. Common tax credit programs that investors access via tax equity structures and that may now be eligible for application of the proportional amortization method include: new markets tax credits, historic rehabilitation tax credit programs, and renewable energy tax credit programs (e.g., solar investment tax credits, on-shore wind production tax credits, and off-shore wind investment tax credits). Other programs that may arise through the Inflation Reduction Act of 2022 may also be eligible.

The proportional amortization method results in (1) the tax credit investment being amortized in proportion to the allocation of tax credits and other tax benefits in each period and (2) net presentation within the income tax line item. This expansion to other investments could simplify the accounting for reporting entities and may provide users with a better understanding of these investments.

The amendments also require incremental disclosures to help investors understand the financial statement impact of investments in tax credit structures. Additionally, the amendments remove specialized guidance for LIHTC investments not accounted for using the proportional amortization method and require those LIHTC investments to be accounted for using applicable GAAP.

The ASU is effective beginning in 2024 for calendar year-end public business entities, including interim periods within those fiscal years. All other entities have an additional year to adopt the new guidance. Early adoption is permitted. If adopted in an interim period, the guidance must be applied retrospectively to the beginning of the fiscal year that includes the interim period.

The [Refundable credits and other benefits not considered "income taxes"](#) section was updated on June 20, 2024 to provide additional interpretation on how to consider transferable credits received from the project in the assessment of the "substantially all" criterion.

## Overview

The US federal tax code, along with a number of state and foreign tax jurisdictions, allows for a variety of tax credits to incentivize certain types of investments and developments. These projects include developments of low-income housing projects, rehabilitation of historic structures, investments in the infrastructure of economically-challenged geographic areas, and renewable energy projects such as solar and wind, among others. Additionally, the Inflation Reduction Act of 2022 (IRA) significantly expanded the availability of climate and energy-related tax credits.

In many cases, the developers and/or operators of such projects may not generate sufficient taxable income to benefit from the governmental tax credits. In response, various investment structures have been developed that involve operating the project using a specifically-created legal entity that is a pass-through entity for tax purposes, with investors investing in the equity of the pass-through entity. In return, the investors receive an allocation of the tax credits and depreciation deductions that the project generates, as well as a portion of the net cash flow generated by the project. These structures often include complex provisions governing the investors' shares of the project's benefits over the life of the project, which are often disproportionate to the investors' ownership percentage. They may also include put or call provisions at various dates that may result in the investor's interests being repurchased for cash.

Typically, these investments have a sponsor, who manages the operations of the project, and one or more "tax equity investors," with all of these parties owning a percentage of the pass-through entity's equity. For the tax equity investor, such investments typically qualify for the equity method of accounting under ASC 323, often due to the guidance in ASC 323-30-S99-1 that states the SEC staff's position that investments in all limited partnerships should be accounted for using the equity method unless the investor's interest is "so minor that the limited partner may have virtually no influence over partnership operating and financial policies," which is generally viewed as investments of less than 3 to 5%. This guidance is typically applied to other legal forms of similar pass-through entities, such as limited liability corporations that are treated as partnerships for tax purposes.

Due to the complex structure of many of these investments and how the tax credits, earnings or losses, and cash distributions are shared between the parties, the investor's share of the investee's earnings or losses under the equity method is often calculated using the hypothetical liquidation at book value (HLBV) method. HLBV calculates the share of investee earnings or losses based on the change in the investor's claim on the net assets of the investee (i.e., how an entity would allocate and distribute its cash if it were liquidated at the carrying value of its assets and liabilities as of the balance sheet date based on its articles of incorporation, bylaws, or other governing documents). For further details on the HLBV method, refer to [Section 4.1.4](#) of our *Equity method investments and joint ventures* guide.

The tax credits and tax benefits of depreciation deductions that are allocated to the investor typically would be included as a benefit in the investor's income tax expense line; however, the investor's share of the project's earnings or losses for financial reporting purposes are reflected in pre-tax income. As a result, there can be inconsistent presentation of the total economic impact of these investments.

The EITF previously addressed this topic, and the resulting guidance in ASC 323-740 allowed for investments in certain tax credit structures to be accounted for using an approach described as the proportional amortization method (PAM) if those investments are made primarily for the purpose of receiving income tax credits and other income tax benefits and meet a number of specified criteria.

Under PAM, the investment in the tax credit structure is amortized in proportion to the income tax credits and other income tax benefits received each period in relation to the total such benefits to be received over the life of the investment. This amortization is presented net of the related tax credits and other tax benefits within the income statement as a component of income tax expense (benefit). The application of PAM is illustrated in the appendix. However, the guidance in ASC 323-740 was limited to investments in qualified affordable housing projects through limited liability entities that generate low-income housing tax credits.

[ASU 2023-02](#) expands the use of PAM to other equity investments in tax credit structures made primarily for the purpose of receiving income tax credits and other income tax benefits that meet certain criteria, which are described in the [Amendments to the guidance and application](#) section. Common tax credit programs that investors access via tax equity

structures and that may now be eligible for application of PAM include new markets tax credits (NMTCs), historic rehabilitation tax credit (HTC) programs, and renewable energy tax credit (RETC) programs (e.g., solar investment tax credits, on-shore wind production tax credits, and off-shore wind investment tax credits). Other programs that may arise through the IRA may also be eligible.

The Board limited the scope of the new guidance to retaining the PAM model and applying the same criteria (with some refinements, as described in the [Amendments to the guidance and application](#) section), as opposed to revisiting the model or considering new models or approaches to investments in tax credit structures.

Under the new guidance, the application of PAM is an accounting policy election made on a tax-credit-program-by-tax-credit-program basis. For those types of investments for which the policy election is made, each investment must still meet the criteria included in ASC 323-740-25-1 to qualify to use PAM.

Even though the guidance has been expanded to other investments and is no longer limited specifically to LIHTC, the criteria are still expected to limit the types of investments that will qualify to use PAM. For example, one of the quantitative criteria is that income tax credits and other income tax benefits must account for substantially all of the projected benefits expected as a return on the investment. Another criterion is that the cash flows generated solely by the income tax credits and other income tax benefits must create a positive projected yield on the investment. As currently structured, a number of RETC programs are not expected to meet the criteria because “substantially all” of the total benefits expected from the investment do not arise from income tax credits and other income tax benefits.

Additionally, although many NMTC structures would meet the economic criteria, they may not be able to use PAM. This is because the investment must be an equity investment in order to apply the guidance within ASC 323-740. Depending on the investment structure, some NMTCs involve intermediate entities that are consolidated, and the only investment in an unconsolidated entity for the project is in the form of a loan. In this case, the investment will likely be accounted for as a debt investment and would not be in the scope of ASC 323. Accordingly, such loans cannot be accounted for using PAM.

The amendments to ASC 323-740 are summarized in this *In depth*. For further details about the application of the existing guidance, refer to [Section 3.3.6](#) of our *Income taxes* guide and [Section 1.3.6](#) of our *Equity method investments and joint ventures* guide.

## Amendments to the guidance and application

### Scope of ASC 323-740

The guidance in ASC 323-740 only applies to the tax equity investor; it does not apply to the project sponsors or other parties (e.g., lenders). For an investment to be within the scope of ASC 323-740 it must be an equity investment in common stock or “in substance common stock” as that phrase is defined in ASC 323-10-20. ASC 323-30-15-3 further extends the guidance in ASC 323 to investments in partnerships, unincorporated joint ventures, and limited liability companies, as long as these instruments are not accounted for as debt securities under ASC 860-20-35-2.

Typical NMTC structures involve multiple entities in which the investor holds equity interests, but the ultimate investment in the project by the lowest-tier entity is in the form of debt. If the investor consolidates the various entities such that the only third party investment is in the form of debt, the structure would not be within the scope of ASC 323-740 and the investor would not be eligible to apply PAM. Judgment is needed to evaluate which entities the investor should consolidate under the guidance in ASC 810, *Consolidation*.

Reporting entities can make a policy election to apply PAM on a tax-credit-program-by-tax-credit-program basis. A “tax credit program” is not specifically defined in the guidance; reporting entities can apply judgment in their particular circumstances as to how they wish to group similar types of investments. Common tax credit programs may include LIHTC, NMTC, HTC, solar, and wind; however, a reporting entity could choose to further segregate on-shore wind programs from off-shore wind programs, segregate investment tax credits from production tax credits, or combine all renewable energy programs, for example. Reporting entities will need to apply their interpretations consistently and should disclose their policies in the financial statement footnotes. One of the reasons for allowing reporting entities to make an accounting policy election by tax credit program is because when a reporting entity expects that only a portion of its investments in a particular tax credit program will meet the criteria to use PAM, their other investments in that program would be accounted for under different methods of accounting. Some reporting entities may prefer that all investments in the same tax credit program be accounted for consistently and therefore may decide not to elect to apply PAM for any investments in these tax credit programs.

### Criteria to use PAM

For any investment in a tax credit program for which the election has been made to apply PAM, the criteria in ASC 323-740-25-1 will be assessed to determine whether the specific investment can be accounted for under PAM. If the investment does not meet all of the criteria, it would be accounted for under other appropriate methods of accounting, such as the equity method. However, the disclosure guidance in ASC 323-740 would still be applicable for these investments. See the [Disclosure requirements](#) section.

[ASU 2023-02](#) retained criteria (a), (b), and (c) in ASC 323-740-25-1 with minor conforming edits. Criteria (aa) and (aaa) were amended. Final language is as follows.

#### ASC 323-740-25-1

A reporting entity that invests in projects that generate income tax credits and other income tax benefits from a tax credit program through limited liability entities (that is, the investor) may elect to account for those investments using the proportional amortization method (described in paragraphs 323-740-35-2 and 323-740-45-2) if elected in accordance with paragraph 323-740-25-4, provided all of the following conditions are met:

- a. It is probable that the income tax credits allocable to the investor will be available.
- aa. The investor does not have the ability to exercise significant influence over the operating and financial policies of the underlying project.
- aaa. 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). Projected benefits include, but are not limited to, income tax credits, other income tax benefits, and other non-income-tax-related benefits, including refundable tax credits (that is, those tax credits not dependent upon an investor’s income tax liability). Tax credits accounted for outside of the scope of Topic 740 (for example, refundable tax credits) shall be included in total projected benefits, but not in income tax credits and other income tax benefits when evaluating this condition. This condition shall be determined on a discounted basis using a discount rate that is consistent with the cash flow assumptions utilized by the investor for the purpose of making a decision to invest in the project.
- b. The investor’s projected yield based solely on the cash flows from the income tax credits and other income tax benefits is positive.
- c. 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.

### Significant influence criterion

The existing significant influence criterion in ASC 323-740-25-1(aa) was retained to make clear that investors that apply PAM should reflect passive investors seeking to principally obtain tax credits and other tax benefits, as opposed to having the ability to be actively involved in the management of the underlying project. Because certain of the tax credit structures that may now be eligible to use PAM involve multiple legal entities, the guidance was amended to clarify that significant influence should be evaluated in relation to the operating and financial policies of the underlying project. The guidance should be considered holistically, consider where in the overall structure the significant operating decisions over the project (versus protective decisions over the tax benefits) are made, and assess the investor's level of influence over such entities.

The term "significant influence" in this criterion is the same as that used in applying the equity method guidance under ASC 323. However, as noted in ASC 323-740-25-1A, this is limited to the indicators of significant influence in ASC 323-10-15-6 and the reminder that judgment is necessary to apply the guidance in ASC 323-10-15-7.

#### ASC 323-10-15-6

Ability to exercise significant influence over operating and financial policies of an investee may be indicated in several ways, including the following:

- a. Representation on the board of directors
- b. Participation in policy-making processes
- c. Material intra-entity transactions
- d. Interchange of managerial personnel
- e. Technological dependency
- f. Extent of ownership by an investor in relation to the concentration of other shareholdings (but substantial or majority ownership of the voting stock of an investee by another investor does not necessarily preclude the ability to exercise significant influence by the investor).

This is not the same threshold for application of the equity method to investments in limited partnerships and other limited liability entities described in ASC 323-10-S99-1, which indicates the SEC staff's position that such investments should be accounted for using the equity method unless the investor's interest is "so minor that the limited partner may have virtually no influence over partnership operating and financial policies," which is generally viewed as investments of less than 3% to 5%.

In some cases, significant judgment will need to be applied to assess whether or not the investor can exert significant influence over the operations of the project, including consideration of the governance structure of the project. For example, holding a board seat may be an indication that an investor can exert significant influence. For further details about evaluating significant influence, refer to [Sections 1.3](#) and [2.1](#) of our *Equity method investments and joint ventures* guide.

### "Substantially all" criterion

One of the most significant criteria in evaluating the overall economics of the investment in the tax credit equity structure and whether the investment was made primarily for the purpose of receiving income tax credits and other income tax benefits is the guidance in ASC 323-740-25-1(aaa) that "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).” This criterion will often be one of the more challenging ones for a number of tax credit programs to meet. Several changes to the criterion were made in the new guidance to better clarify how the calculations should be performed.

As discussed in paragraph BC19 of [ASU 2023-02](#), the EITF observed that “substantially all” is not a defined term in GAAP and that it did not intend to change how the phrase is applied in ASC 323-740-25-1(aaa) or in other areas of GAAP (e.g., leases, assessing the definition of a “business”). There is no bright line, but it is typically interpreted to mean at least 90%.

*Refundable credits and other benefits not considered “income taxes” (updated June 2024)*

Some credits or other tax incentives may be monetized through the income tax return or in some other manner (e.g., direct cash payments received from the government, the sale of tax credits to other taxpayers) at the option of the taxpayer. While credits and incentives often arise in the tax laws and may be claimed on a tax return, they may not be subject to ASC 740 for accounting purposes depending on their nature. There are also credits related to other types of taxes (e.g., premium taxes) in certain industries; these are not considered to be “income taxes” and are not within the scope of ASC 740. Each credit and incentive must be analyzed to determine whether it should be accounted for under ASC 740 or whether it is subject to other guidance. For further consideration, refer to [Section 1.2.4](#) of our *Income taxes* guide.

[ASU 2023-02](#) clarified that for the purposes of applying the substantially all test, the existence of refundable tax credits (or other taxes not in the scope of ASC 740) in a tax credit structure does not automatically preclude an investor from applying the proportional amortization method. However, we believe only income tax credits and other benefits accounted for under ASC 740 at the investor level are eligible for consideration as income tax benefits in the substantially all test. If an investor could be allocated a tax credit that is refundable to the investor, that credit would be included in the denominator (as a portion of the total projected benefits from the investment) but not in the numerator of the substantially all test. Excluding refundable tax credits from the numerator is consistent with the accounting treatment of a refundable tax credit as a grant and not as an income tax benefit within the scope of ASC 740. For IRA credits, refundable credits generated by an investee would not be refundable if allocated to an investor for use on the investor’s tax return. As a result, we believe an investor could include such tax credits in both the numerator and denominator for purposes of the substantially all test.

In addition, the IRA introduced provisions for certain types of credits to be transferable (i.e., they can be sold for cash) by the initial recipient of the credit to third parties. In the context of these tax credit structures, we understand that the investee would be the entity that receives the tax credits, and the investee must make the election each year to either pass the tax credits through to its investors for use on their tax returns or sell the tax credits to another taxpayer for cash (and presumably distribute such cash to investors). Once allocated to the investor, the credits are no longer transferable. In many cases, the tax equity investor controls the decision as to whether the investee will sell the credits or allocate them to the investor. In that fact pattern, the partnership is essentially acting as an agent on behalf of the investor, but the credits effectively belong to the investor via the terms of the partnership agreement. As a result, if the investor accounts for transferable credits under ASC 740, we believe the investor may treat a transferable credit as an income tax benefit that is includible in the numerator when evaluating the substantially all test.

*Discounted cash flows and income tax benefits*

The updated guidance indicates that all of the cash flows and income tax benefits arising from the project should be discounted in applying the substantially all test. The standard does not specify what discount rate should be used, but rather indicates that the discount rate should be consistent with the cash flow assumptions utilized by the investor for the purpose

of making a decision to invest in the project. This aligns the assessment of whether the investment was made primarily for the purpose of receiving income tax credits and other income tax benefits with the reporting entity's investment decision. Similarly, we believe the cash flow assumptions used in the calculation (e.g., anticipated tax credits and other tax benefits, operating cash flows from the project over the life of the investment, disposal date, sale proceeds, exercise of a put or call option) should reflect the investor's cash flow assumptions used in making its investment. The tax benefits and cash flows should be considered over the reporting entity's expected life of the investment, which may be less than the life of the underlying project (as these investments typically include put and/or call options that are exercised by one of the parties).

## Applying the proportional amortization method

While the new guidance did not change the basic PAM model, [ASU 2023-02](#) resulted in changes or clarifications in the guidance related to applying PAM.

### "Flow-through" method for investment tax credits

The guidance was amended to clarify that when a reporting entity applies PAM, it must use the "flow-through" method for investment tax credits (ITC) as described in ASC 740-10-25-46. That is the case even if the reporting entity has otherwise elected the "deferral" method of accounting for other investment tax credits. Under the flow-through method, the tax benefit from an ITC is recorded in the period that the credit is generated as a current income tax benefit. Conversely, under the deferral method, the tax benefit from an ITC is deferred and amortized over the financial reporting life of the underlying asset. For further details of the flow-through and deferral methods, refer to [Section 3.3.5.1](#) of our *Income taxes* guide.

This amendment was made because the Task Force concluded that the objective of the deferral method is inconsistent with PAM and could result in additional complexity. If a reporting entity had previously applied the deferral method of accounting for ITCs to an investment that will now be eligible for PAM, it will need to unwind this accounting as part of the cumulative effect of adopting the new guidance.

### Presentation of cash and other benefits not considered "income tax" benefits

The presentation in the income statement under PAM did not change in [ASU 2023-02](#), although there were certain minor conforming clarifications. Under PAM, all income tax benefits (both credits and other benefits, such as the tax benefit of depreciation deductions) are reflected in the income tax expense line, along with amortization of the investment cost (excluding any residual value, such as the estimated put or call price, determined on an undiscounted basis) in proportion to the tax benefits received during the period, all as described in ASC 323-740-35-2. However, ASC 323-740-35-5 states that any non-income-tax-related benefits received from the investee (which could either be cash flow from operations or credits that are not considered income taxes under ASC 740) should be included in pre-tax earnings when realized or realizable. Similarly, any gains or losses on the sale of the investment should also be included in pre-tax earnings at the time of sale.

### Delayed equity contributions

In some investment structures, the investor may fund certain contributions at inception, and may also agree to fund additional amounts in the future, either upon fixed dates, request by the project sponsor, or resolution of a defined contingent event. These are referred to in ASC 323-740 as "delayed equity contributions." The ASU amends the delayed equity contribution guidance so that it is now applicable to all investments that are accounted for using PAM, but cannot be applied to investments that are not accounted for using PAM (including LIHTC investments - see the [Amendments specific to LIHTC](#) section).

For all investments accounted for using PAM, reporting entities are required to gross up the balance sheet for delayed equity contributions related to the investment if they are

unconditional and legally binding, or, if they are contingent upon a future event, when that contingent event becomes probable. This results in an increase to the carrying value of the investment and a related liability being recorded for delayed equity contributions.

The Task Force acknowledged that future equity contributions, even if contractually committed, may not meet the conceptual definition of a liability. However, from a reporting perspective, there are benefits of recording delayed equity contributions when applying PAM as it creates a smoother (and single) amortization schedule. This is because if equity contributions are recorded after some of the tax benefits have been received, the amortization schedule would need to be adjusted to include the additional equity contributions and would need to be trued up to account for the additional investment. This could also result in back-loading the cost of the investment in the amortization process; that was considered to be inconsistent with the objective of PAM, which is to have a smooth recognition of the net effects of the investment in the income tax expense line item over time.

### Impairments

Investments accounted for using PAM must continue to use the impairment guidance in ASC 323-740-35-6.

#### ASC 323-740-35-6

An investment shall 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 shall be measured as the amount by which the carrying amount of an investment exceeds its fair value. A previously recognized impairment loss shall not be reversed.

This differs from the other-than-temporary impairment (OTTI) guidance applicable to other equity method investments (not using PAM) under ASC 323-10-35-32, which in some circumstances requires more judgment in assessing whether the investment is impaired.

### Reassessments

There were no amendments to the existing requirement in ASC 323-740-25-1C to reassess the eligibility of an investment for the proportional amortization method upon a change in the nature of the investment or a change in the relationship with the project sponsor. However, the Task Force generally agreed that various other events, such as changes in the tax law or modifications of the investment agreements, that significantly affect the economics of the investment would meet this requirement.

The Task Force discussed whether upon a reassessment a reporting entity should perform the analysis over the entire life of the investment (including historical tax benefits and cash flows beginning from the initial investment, along with the remaining projected tax benefits and cash flows) or perform the analysis prospectively (only the remaining projected tax benefits and cash flows). Although not explicitly stated in the ASU, the Task Force concluded that the reassessment should include all tax benefits and cash flows over the life of the investment and that it would not be appropriate to exclude the historical amounts.

No explicit guidance was included in the standard as to how such calculations, in particular how to incorporate a discounted calculation at a date in the middle of the overall project, should be performed, but reasonable judgments should be made.



## Amendments specific to LIHTC

ASC 323-740 included specialized guidance for all LIHTC investments, regardless of whether they were accounted for using PAM. [ASU 2023-02](#) removes these limited exceptions so that LIHTC investments will now be accounted for under other applicable GAAP if they do not qualify for PAM or the reporting entity elects not to apply PAM to LIHTC investments. In general, the ASU changes the specialized accounting from applying to all LIHTC investments to applying to any investment that is accounted for using PAM.

The three amendments of this nature are as follows:

- Remove the cost method for LIHTC investments that was previously grandfathered under ASC 323-740-25-2A. LIHTC investments that are not accounted for under PAM or the equity method of accounting will now apply the equity investments guidance in ASC 321, *Investments – Equity Securities*. [Chapter 2](#) of our *Loans and investments* guide covers the application of ASC 321.
- Remove the previous impairment guidance that was applicable to LIHTC investments applying the equity method rather than PAM. This guidance allowed reporting entities to compare the carrying value of the LIHTC investment to future benefits, resulting in an undiscounted cash flow impairment model. Under [ASU 2023-02](#), these LIHTC investments that are not accounted for using PAM will now follow the OTTI equity method impairment guidance under ASC 323-10-35-32.
- Remove the guidance in ASC 323-740-25-3 related to delayed equity contributions for LIHTC investments that do not use PAM. Other applicable GAAP, such as ASC 440, *Commitments*, or ASC 460, *Guarantees*, will now apply to these commitments.

The specific transition provisions for these LIHTC-specific amendments are discussed in the [Transition](#) section.

## Disclosure requirements

A significant component of the new guidance is to provide financial statement users with additional information about a reporting entity's investments in tax credit structures and their impact on reported financial results. Accordingly, a number of new disclosures were added to include additional information about amounts reflected in the balance sheet, income statement, and statement of cash flows from these investments.

These disclosures are required not only for investments that are being accounted for under PAM, but all investments within the tax credit programs for which the reporting entity has elected to apply PAM, including investments within that elected program that do not meet the conditions to apply PAM. A reporting entity could also choose to provide information about investments in tax credit programs for which the entity has elected not to apply PAM to better highlight amounts reflected in pre-tax income and income tax expense associated with all investments in tax credit structures.

The following disclosure requirements are applicable for both annual and interim periods:

- The amount of income tax credits and other income tax benefits recognized during the period, including the income statement and statement of cash flows line items in which it has been recognized
- The amount of investments and the balance sheet line item in which the investments are recognized
- For investments accounted for using PAM, the amount of investment amortization recognized as a component of income tax expense (benefit)

- For investments accounted for using PAM, the amount of non-income-tax-related activity and other returns received that is recognized outside of income tax expense (benefit) and the income statement and statement of cash flows line items in which it has been recognized
- For investments accounted for using PAM, 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

A reporting entity should also consider the following disclosures:

- 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(s) 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, those impairment losses may be based on actual property-level foreclosures, loss of qualification due to occupancy levels, compliance issues with tax code provisions, or other issues.)

## Effective dates and transition

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

Early adoption of the ASU is permitted, including in an interim period. If an entity elects to early adopt the ASU in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes the interim period. For example, if a calendar year-end entity adopts this guidance in the second quarter of 2023, it will adopt the guidance as of January 1, 2023.

## Transition

All amendments in the ASU can be adopted on either a retrospective or a modified retrospective basis. The same transition method should be applied to all amendments, except for the LIHTC-specific amendments, which can be adopted using a prospective transition method instead.

The transition date for reporting entities that choose the retrospective transition method is the beginning of the earliest period presented. The transition date for those entities that choose the modified retrospective transition method is the beginning of the fiscal year of adoption.

As of the transition date, reporting entities will evaluate all applicable investments in tax programs for which the reporting entity elects to apply PAM and for which it still expects to receive income tax credits or other income tax benefits. The assessment of whether applicable investments qualify to use PAM under the criteria in ASC 323-740-25-1 is performed as of the date that the investment was entered into, or as of a subsequent “reassessment” date if applicable. In applying the substantially all test, the reporting entity will need to include actual benefits received as of the transition date in addition to remaining expected future benefits.

If there are delayed equity contributions associated with an investment that qualifies for PAM, the reporting entity should use actual equity contributions made and remaining equity contributions expected to be made as of the transition date to calculate the appropriate amounts to record upon adoption.

On the transition date, reporting entities will record a cumulative effect adjustment to retained earnings. The cumulative effect adjustment is the difference between the previous accounting and new accounting since the initial date of each impacted investment.

#### Transition for LIHTC-specific amendments

For the three specific LIHTC-specific amendments (i.e., elimination of the cost method, elimination of the impairment exception for LIHTC equity method investments, and elimination of the delayed equity contribution guidance for LIHTC investments that do not apply the proportional amortization method), a reporting entity can apply the same transition method as other amendments or a prospective transition method. The transition method can be elected independently for each of these three amendments. A prospective transition means retaining existing investment balances upon adoption and then beginning to follow the new guidance as of the beginning of the fiscal year of adoption. This is different from “grandfathering” existing investments and only applying the new guidance to new investments.

- Adopting the prospective transition method for LIHTC investments transitioning from the cost method means that the carrying value of the investment at the beginning of the fiscal year of adoption would be considered the starting cost basis of the investment in applying the new guidance under ASC 321. This could result in a “day 2” gain or loss if the measurement under ASC 321 is different than the cost basis.
- Adopting the prospective transition method for equity method LIHTC investments could result in a day 2 loss because of the change in impairment testing methodology.
- For LIHTC investments transitioning from the delayed equity contribution guidance because they do not qualify for PAM, on the date of transition the reporting entity will derecognize any delayed equity contribution liability and adjust the corresponding LIHTC investment cost basis.

In any of these situations, instead of using a prospective transition method, the reporting entity could elect to apply one of the other transition methods to avoid an immediate day 2 accounting impact.

#### Transition disclosures

Reporting entities must make the following transition disclosures, consistent with ASC 250 on accounting changes and error corrections:

1. The nature of and reason for the change in accounting principle
2. The transition method and a description of prior-period information that has been retrospectively adjusted, if any
3. The effect of the change on income from continuing operations, net income, and any affected per-share amounts for the prior periods retrospectively adjusted, if applicable
4. The cumulative effect of the change on retained earnings and the period in which this is reflected
5. A qualitative description of the financial statement line items affected by the change.

Reporting entities that issue interim financial statements need to provide these disclosures in the financial statements of both the interim period of the change and the fiscal year of the change.

## Impact of adoption on SEC filings

As described in the [Transition](#) section, when adopting the new guidance using the modified retrospective approach, an entity will adopt it as of the beginning of the fiscal year. If a calendar year-end public business entity early adopts the new guidance in an interim period, it will reflect the change as of January 1. If adopted in other than the first quarter, reporting entities will need to assess the materiality of the modified retrospective adoption and the impact to previously issued Form 10-Qs in the year of adoption in connection with capital markets transactions or registration statements.

When adopting the new guidance on a retrospective basis, an entity will adopt it as of the beginning of the earliest period presented. Reporting entities will need to assess the materiality of the retrospective adoption and the impact to previously issued financial statements (Form 10-K/Qs) in connection with any new or amended registration statement and should consult with their auditors and SEC counsel to determine whether previously issued Form 10-K/Q(s) may be required to be recast (e.g., via a Form 8-K) in connection with capital markets transactions and/or registration statements. If it is determined that previously issued Form 10-K/Q(s) do not need to be recast, the entity will conform the prior period to the current period presentation in subsequent Form 10-K/10-Q filings.

Reporting entities may also need to consider the impact of the adoption on quarterly supplementary financial information or voluntarily disclosed selected financial data in the Form 10-K to determine if recasting of these disclosures is necessary.

Under either transition method, any post-adoption 10-Q and 10-K filings should also include appropriate disclosures discussing the adoption of the new accounting principle.

Lastly, entities should consider if there were any changes in internal controls over financial reporting (ICFR) that have a material impact on ICFR reporting in the period of adoption that may need to be disclosed in Item 4 of the Form 10-Q, or Item 9A of the Form 10-K if [ASU 2023-02](#) is adopted in the fourth quarter.

### To have a deeper discussion, contact:

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## Appendix - Example of the application of the proportional amortization method

On January 1, 2023:

- Investor A made a \$1M investment in a renewable energy project in return for a 5% limited partnership interest.
- The project is eligible for a tax credit. Investor A anticipates it will receive an annual tax credit allocation of \$100,000 each year for 8 years. There is no reduction of the project's tax basis as a result of the income tax credits. The income tax credits are not subject to recapture. Investor A's tax rate is 25%.
- Investor A plans to sell its investment on December 31, 2032 for an estimated residual value of \$50,000 pursuant to a put right in the partnership agreement.
- Investor A will receive cash distributions, which it expects to amount to \$2,000 per year, based on a fixed percentage of the project's net cash flow over the life of the project.

This example assumes that all cash flows, except for the initial investment, occur on December 31 of each year. Depreciation expense is computed for book and tax purposes using the straight-line method with a 10 year life.

Investor A has elected to use PAM to account for its tax equity investments in this type of tax credit program in accordance with paragraph ASC 323-740-25-4. All of the criteria described in paragraph ASC 323-740-25-1 are met.

How should Investor A determine its annual amortization and recognize cash proceeds for its tax equity investment under PAM?

### Analysis

Year	Net investment (1)	Amortization of investment (2)	Income tax credits (3)	Net tax losses (4)	Other income tax benefits from tax losses (5)	Income tax credits and other income tax benefits (6)	Income tax credits and other income tax benefits, net of amortization (7)	Non-income tax-related cash returns (8)
1	\$885,448	\$114,552	\$100,000	\$98,000	\$24,500	\$124,500	\$9,948	\$2,000
2	770,896	114,552	100,000	98,000	24,500	124,500	9,948	2,000
3	656,344	114,552	100,000	98,000	24,500	124,500	9,948	2,000
4	541,792	114,552	100,000	98,000	24,500	124,500	9,948	2,000
5	427,240	114,552	100,000	98,000	24,500	124,500	9,948	2,000
6	312,688	114,552	100,000	98,000	24,500	124,500	9,948	2,000
7	198,136	114,552	100,000	98,000	24,500	124,500	9,948	2,000
8	83,584	114,552	100,000	98,000	24,500	124,500	9,948	2,000
9	61,041	22,542	0	98,000	24,500	24,500	1,958	2,000
10	50,000	11,041	0	48,000 *	12,000	12,000	959	52,000 *
<b>Total</b>		<b>\$950,000</b>	<b>\$800,000</b>	<b>\$930,000</b>	<b>\$232,500</b>	<b>\$1,032,500</b>	<b>\$82,500</b>	<b>\$70,000</b>

(1) End-of-year carrying amount of the investment net of amortization in column (2)

(2) Initial investment of \$1M less expected residual value of \$50,000 x (income tax credits and other income tax benefits received during the year in Column (6)) / total anticipated income tax benefits over the life of the investment of \$1,032,500)

(3) Income tax credits allocated to the investor for the year

(4) Income tax losses, principally from depreciation, passed on to the investor for the year

(5) Column (4) x 25% tax rate

(6) Column (3) + Column (5)

(7) Column (6) – Column (2)

(8) Non-income-tax-related benefits, representing the cash proceeds (a) received by the investor based on the cash generated by the project and (b) upon exercise of the put right (net of the remaining carrying amount of the investment at that time), are recognized in current period pre-tax earnings when received

\*The net tax loss in year 10 reflects the income tax loss passed on to the investor from the investee, net of the tax gain on the proceeds received upon exercise of the put right. Likewise, the non-income tax-related cash returns include \$50,000 in proceeds received upon exercise of the put right.