

Changing Accounting Standards Could Accelerate a Clean Energy Transition

by Michael Bernier

Michael Bernier is a partner at EY LLP.

In this article, Bernier argues that expanding Accounting Standards Update 2014-01 to other tax credit investments, including renewable energy transactions, could reshape the tax equity market.

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Twelve years ago, Nassim Nicholas Taleb brought the term “black swan” into mainstream business jargon with the publication of his book, *The Black Swan: The Impact of the Highly Improbable*. Over time, the meaning has morphed from an improbable event — how it was laid out in the book — to an event that isn’t front of mind. That newer definition describes something that’s going on right now in the world of accounting that I think more people should know about. While much talk has been focused on the Growing Renewable Energy and Efficiency Now Act (H.R. 848), the Build Back Better Act (H.R. 5376), and direct-pay options for renewables, a different enterprise has been progressing quietly in the background that has the potential to be even more significant.

What is it? Well, it’s the Emerging Issues Task Force project to evaluate whether it’s appropriate to expand Accounting Standards Update (ASU) 2014-01, “Accounting for Investments in Qualified Affordable Housing Projects,” to other tax credit investments, including renewable energy transactions. The task force is the interpretive body of the Financial Accounting Standards Board. Why does this matter? Simply put, it could

make tax equity investments in renewable energy much more popular, helping with the transition to clean energy.

First, some background: Over the past 12 months, I’ve been getting an increasing number of calls from clients and potential clients who want to learn more about tax equity investing in renewable energy projects — driven in part by the growing prevalence of environmental, social, and governance considerations. I walk these parties through the different factors, and most of them (anecdotal 70 percent) decide these investments aren’t the right fit. A vast majority hit the proverbial reject button when I get to four dreaded letters: HLBV, which stands for hypothetical liquidation at book value. And that’s unfortunate because every potential tax equity investor who sits on the sidelines instead of investing in renewable energy increases the cost of tax equity, makes projects less economical, and reduces the amount of renewable electricity being generated — which increases our dependence on more carbon-intensive forms of generating electricity.

What is HLBV? Renewable energy tax equity investments are most commonly structured as flip partnerships in which the allocations automatically flip based on predetermined events laid out in the partnership agreement. For example, an investor may receive 99 percent of taxable income and 10 percent of cash until a target after-tax internal rate of return is met; thereafter, the investor receives 5 percent of taxable income and 5 percent of cash. These so-called flip structures are designed to provide the investor with economic protection, but some believe the accounting doesn’t reflect the economics of the transaction.

Normally when you make an investment that you're accounting for under "vanilla" equity method accounting, you calculate your earnings by taking the earnings of the partnership and multiplying that by your ownership percentage: "The partnership made \$100, and I own 30 percent of the partnership, so I made \$30." It's simple and straightforward. But in a flip partnership, you don't have a single ownership percentage. In the example above, is the investor a 99 percent owner since that is their pre-flip tax allocation, a 10 percent owner because of the pre-flip cash allocation, or a 5 percent owner since that is their post-flip allocation? Under HLBV, you hypothetically liquidate the assets of the partnership at their then generally accepted accounting principles carrying value and distribute the proceeds of that liquidation via the terms of the partnership agreement. The value of the investment is the amount that you would receive in liquidation, and your income or loss is your change in carrying value (adjusted for cash contributions and distributions).

While this may sound complex, it's even more challenging than you are likely thinking. Most partnership agreements require that liquidation be done in accordance with positive capital accounts, meaning that you have to first calculate the tax gain on liquidation and then allocate that gain to the various partners following all the requisite partnership tax rules. This is an accounting concept that requires tax expertise to do correctly. Further, because of various book-tax differences, most notably depreciation, the

change in liquidation proceeds does not mirror the after-tax economics of the period. For example, you could be depreciating the assets under a five-year modified accelerated cost recovery system for tax (20 percent in year 1) yet depreciating it over 25 years for GAAP (4 percent in year 1). Add in the fact that renewable energy production tax credits provide an after-tax benefit but do not affect the book carrying value, and you start to see a separation from what you actually received and expect to receive and what is your carrying value in liquidation.

Before we look at how HLBV plays out in a sample deal, we also need to address the accounting for the investment tax credit. Under GAAP guidance, two different approaches can be taken when accounting for ITCs: the deferral method or the flow-through method. Under the flow-through method, the ITC flows through to the income tax line, reducing income tax expense. If applying the deferral method, then the ITC is accounted for as a reduction in the investment rather than in the income tax expense line items. While the investment is a balance sheet line item, the ITC will eventually make it into the income statement through some combination of lower impairment or higher gain/lower loss on exit.

Below is the GAAP income statement for a solar tax equity transaction. Table 1 demonstrates how the investment would look under the deferral method of accounting, with Table 2 showing how that same investment would look if the ITC were accounted for using the flow-through method.

Table 1

ITC HLBV: Deferral	Cumulative Total	2021	2022	2023	2024	2025	2026
Ending carrying value		\$48,177	\$33,121	\$18,081	\$3,435	\$421	\$10,000
Pretax operating income	\$1,004	\$39,697	(\$13,303)	(\$13,364)	(\$12,903)	(\$1,100)	\$1,978
Impairment recognized	—	—	—	—	—	—	—
Gain on sale	\$9,556	—	—	—	—	—	\$9,556
Total pretax income	\$10,561	\$39,697	(\$13,303)	(\$13,364)	(\$12,903)	(\$1,100)	\$11,534
Below-the-line income	\$3,534	\$1,181	\$2,794	\$2,806	\$2,710	(\$921)	(\$5,035)
Net income	\$14,095	\$40,878	(\$10,509)	(\$10,558)	(\$10,194)	(\$2,022)	\$6,499

Table 2

ITC HLBV: Flowthrough	Cumulative Total	2021	2022	2023	2024	2025	2026
Ending carrying value		\$52,678	\$37,470	\$22,277	\$7,478	\$4,312	\$10,000
Pretax operating income	(\$85,899)	(\$46,443)	(\$13,455)	(\$13,517)	(\$13,056)	(\$1,253)	\$1,825
Impairment recognized	—	—	—	—	—	—	—
Gain on sale	\$5,818	—	—	—	—	—	\$5,818
Total pretax income	(\$80,082)	(\$46,443)	(\$13,455)	(\$13,517)	(\$13,056)	(\$1,253)	\$7,643
Below-the-line income	\$94,176	\$90,878	\$2,826	\$2,839	\$2,742	(\$889)	(\$4,218)
Net income	\$14,095	\$44,434	(\$10,630)	(\$10,678)	(\$10,314)	(\$2,142)	\$3,425

There are a few takeaways from looking at the two tables. First, both the deferral and flow-through methods create an unevenness in net income that may be unattractive to many potential investors. Under both approaches, the first-year net income is great but followed by three negative years. The flow-through method also results in a pretax loss of \$86 million, which lowers the pretax and operating profits of the investor — a common metric that is used by Wall Street — but does provide a \$94 million tax benefit by lowering the investor's effective tax rate.

How are low-income housing tax credit (LIHTC) investments accounted for? They have special guidance under ASU 2014-01, which allows for what is referred to as proportional amortization. Under proportional amortization, the investment is amortized based on the percentage of expected benefits received in that period. So if you received 10 percent of the benefits that you expect to get over the life of the

investment, you would amortize 10 percent of the investment in that period. Also, the amortization goes into the tax provision, so there is no below-the-line drag. Let's assume you invested \$90 into an LIHTC investment that was supposed to return \$100 of tax benefits and cash. Under proportional amortization, you would have a \$10 reduction in tax expense over the life of the investment. Table 3 shows the same investment as above would look if ASU 2014-01 were applied.

Here the earnings are the same as the two examples above, but everything is positioned in the tax provision. Further, none of the years show negative earnings. Many investors I have talked with show a strong preference for investments with this type of profile.

Are there any catches? Yes. For an LIHTC investment to qualify for proportional amortization, it must meet five criteria:

1. It is probable that the tax credits allocable to the investor will be available.

Table 3

ITC ASU 2014-01 Application	Cumulative Total	2021	2022	2023	2024	2025	2026
Ending carrying value		\$26,337	\$14,999	\$10,931	\$6,889	\$3,901	—
Pretax operating income	—	—	—	—	—	—	—
Impairment recognized	—	—	—	—	—	—	—
Gain on sale	—	—	—	—	—	—	—
Total pretax income	—	—	—	—	—	—	—
Below-the-line income	\$14,095	\$10,383	\$1,598	\$573	\$570	\$421	\$550
Net income	\$14,095	\$10,383	\$1,598	\$573	\$570	\$421	\$550

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

If the guidance is expanded to other tax credit investments, meeting the third item on the list might be challenging. The standard renewable energy flip transaction follows the form of tax equity: The investor receives a significant amount of tax benefits and a small amount of cash; after the flip, the investor is bought out either via the investor executing a put option or by a cash equity investor executing a call option. In the standard transaction in which the tax equity investor is bought out, it is highly likely that substantially all the projected benefits are from tax credits and other tax benefits. If the investor is not bought out, the investor may be stuck collecting small amounts of cash that will inevitably add up over time, putting pressure on whether substantially all the benefits are tax benefits. Can investors assume they are going to execute the put? That's tricky. If the intention from the beginning was to execute the put option, that puts pressure on the tax treatment of the investment. While we're all familiar with book-tax differences like depreciation, you can't intend to hold it for tax and intend to sell it for GAAP.

Also, if we look at item 5, it is common for renewable energy transactions to have a deficit restoration obligation (DRO). A DRO allows a partner's capital account to go negative up to the amount of the DRO as opposed to having to stop at \$0. This allows for additional flexibility when optimizing the allocation of tax items between the tax equity investor and the cash equity investor. However, a DRO could be considered to violate the fifth prong.

That said, I would expect that if the proportional amortization method is adopted, most transactions would be structured to meet the requirements of ASU 2014-01. A deeper market for tax equity would result in a cheaper cost of capital, which would more than make up for the potential of suboptimal structuring. ■