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FEES PAID TO DEVELOPERS OF QUALIFIED AFFORDABLE HOUSING PROJECTS

February 2020

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Fees Paid to Developers of Qualified Affordable Housing Projects

Overview

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-09, which modified the accounting under ASC Topic 606 *Revenue from Contracts with Customers* ("Topic 606"). These modifications become effective for non-public entities' annual reporting periods beginning after Dec. 15, 2018. The accounting for fees paid to a developer of a qualified affordable housing project ("QAHP") will be impacted by the new guidance when it becomes effective.

The core principle under Topic 606 is that revenue is recognized "to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."[1] Recognition of revenues under Topic 606 in accordance with the core principle is based on application of a five-step process, which is summarized below:

Step 1: Identify the contract with a customer
Step 2: Identify the performance obligations in the contract
Step 3: Determine the transaction price
Step 4: Allocate the transaction price to the performance obligations in the contract
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Fees paid to developers of QAHPs are significantly different from fees paid to developers of conventional property ownership entities. This difference is caused by the related party relationship between the developer and the QAHP. In conventional property ownership entities, the developer is an unrelated third party and the accounting for fees paid to the developer is relatively straightforward.

The relationships between the parties to a QAHP create a situation in which substance over form should be considered in the application of Topic 606. In form, the contract is a developer services agreement between an entity that provides developer services and the limited partnership or limited liability entity that has legal ownership of the real estate being developed. However, the substance of the transaction is more complex, because the entity that performs developer services, a related party to the general partner of the QAHP, has performed a major part of its services before the QAHP was formed. The reason these services must be carried out before the formation of the QAHP is because several components of the project are required to be in place prior to preliminary allocation of credits and the arrangement of debt instruments for the project, without which there would not be any incentive to invest in the project. The source of funding to compensate the developer services entity for those services is the unrelated investor parties in the QAHP. Thus, only the entity who performed the services prior to the formation of the QAHP can be the seller in the developer services agreement, in order for that entity to receive compensation. In substance, therefore, the transaction is between 1) related parties who identify and develop QAHPs prior to their formation, and 2) unrelated investors who compensate the developers for their services in exchange for the right to receive all the tax credits and tax benefits of the QAHP.

Unique nature of QAHPs

The characteristics that make QAHPs unique are described in ASC 323-740, which addresses investments in QAHPs. The FASB recognized a difference between the form and the substance of a QAHP investment. The form of the investment, which is required for tax purposes, is an equity ownership interest in the QAHP. However, the substance of that investment is much different. Investors

[1] ASC 606-10-05-3

in QAHPs expect to receive substantially all their return from tax credits and other tax benefits, rather than from operating cash flows or capital appreciation of the underlying property.

Affordable Housing Developers, or AHDs, are in the business of acquiring, developing, owning, and operating QAHPs. An important source of financing the acquisition, construction, and other costs expected to be incurred by the QAHP is provided by investor capital obtained through the sale of an investment ownership interest in the QAHP to a third-party investor. The AHD retains an ownership interest in the QAHP, usually in the form of a general partnership or managing member interest.

AHDs invest significant time and effort identifying and evaluating development opportunities. This work is usually performed by a separate development services entity ("DSE"), which usually is owned and controlled by the AHD. Once an identified development opportunity is considered viable, the DSE will commit significant resources to obtaining the additional components necessary to make the opportunity attractive to investors, such as a commitment from a construction contractor, loan commitments from financial institutions, and a preliminary tax credit allocation from a tax credit agency ("TCA").

Once the needed components are in place, the AHD will market the prospective project to investors. If successful, a new entity is formed to be the QAHP, and the underlying real estate is acquired. Funding of the acquisition usually consists of a combination of loan proceeds and investor capital. At closing, the QAHP will reimburse the DSE for any direct costs of development it incurred. In addition, the QAHP will enter into a development services agreement ("DSA") with the DSE.

A QAHP is a separate, stand-alone ownership entity. QAHPs usually are limited partnerships or limited liability entities, which are flow-through entities for income tax purposes. This structure is necessary because the tax credit allocation from the federal government is attached to the eligible portion of the depreciable cost basis of the underlying real estate and is subsequently allocated to owners in tandem with allocations of the related depreciation. As a result, the only way an investor can receive the tax credits is through an ownership interest in the QAHP.

In summary, the third-party investor's primary reason for making an investment in a QAHP is to obtain the rights to the QAHP's tax credits and to receive other tax benefits related to the investment. The capital invested by the third-party investor in the QAHP provides funding for the QAHP, which is used to help finance the cost of acquiring and developing the property.

Step 1: Identify the contract(s) with a customer

The customer in a QAHP revenue transaction is the third-party investor, and the contract with the third-party investor primarily consists of the QAHP ownership agreements.

Fees paid by an owner of real estate to a developer for services related to oversight of construction and related development activities of leasehold improvements in conventional real estate is considered a contract with a customer. The customer in such situations is the property owner, and the contract is the DSA. The performance obligation under that contract is delivery of the constructed leasehold improvements. Control of the leasehold improvements is transferred to the owner through its ownership of the underlying real estate.

While certain attributes of a conventional development services transaction exist in a QAHP transaction, such as the DSA between the QAHP and the DSE, the relationship between the AHD and the DSE is different from what it is in a conventional transaction, and that difference significantly impacts determination of both the customer and the contract, as described below.

The customer

Under Topic 606, a customer is defined as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."[2]

Topic 606 places significant emphasis on the transfer of control in accounting for revenue from contracts with customers.[3] The guidance requires transfer of a promised good or service, which is considered an asset, to the customer. "Control of an asset refers to the ability to direct the use of, and obtain substantially all the remaining benefits from, the asset," Topic 606 states.

The DSE in a QAHP transaction does not qualify as a customer under Topic 606 because it is controlled by the AHD. The AHD's control over the DSE, when combined with the AHD's ownership interest in the QAHP, effectively precludes any transfer of control over the constructed leasehold improvements by the DSE to the QAHP. As a result, the AHD is unable to earn any revenue for the services it provides to the QAHP under the DSA with the DSE.

In a QAHP, the only good or service for which control is transferred from one party to another is the right to receive the tax credits awarded to the QAHP. The transfer of control of those rights is made by the AHD to the third-party investor through its investment in the QAHP. Further, the third-party investor is the only party in a QAHP that provides substantive consideration. In our view, the customer (in substance) in a QAHP development fee revenue transaction is the third-party investor. The good or service being transferred through satisfaction of the performance obligation is the right to receive the low-income housing tax credits ("tax credits") allocated to the QAHP. The contract primarily consists of the QAHP ownership agreements, although certain elements of the DSA also impact the transaction with the customer.

The contract

In a QAHP revenue transaction, the contract with the third-party investor is composed of the QAHP ownership agreements and related documents. The DSA, which is integral to achievement of the performance obligations set forth in the QAHP ownership agreements, is also considered part of the contract with the third-party investor. Together, these agreements are deemed to have a single commercial objective and interdependence of consideration to be paid.[4]

Step 2: Identify the performance obligations in the contract

The primary performance obligation in the contract is to take the necessary actions to enable the QAHP to qualify for a final allocation of tax credits with the appropriate TCA.

The AHD's role under the QAHP ownership documents (the "contract") is to enable the QAHP to meet the requirements necessary to obtain a final allocation of tax credits. The resulting asset consists of the rights to receive those tax credits. Control over that asset is transferred to the third-party investor through their investment in the QAHP. A proportionate ownership interest in the underlying real estate owned by the QAHP is not transferred to the third-party investor.

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[2] ASC 606-10-15-3
[3] ASC 606-10-25-23
[4] See ASC 606-10-25-9 for additional information regarding combining contracts.

Why the constructed property improvements are not included as an asset under the performance obligation

The promises in the DSA and QAHP ownership agreements both explicitly and implicitly describe actions the AHD is required to perform to ensure the QAHP qualifies for a final allocation of tax credits. ASC 606-10-25-16 addresses explicit and implicit promises and states, in part (emphasis added):

> *…the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a reasonable expectation of the customer that the entity will transfer a good or service to the customer.*

Requirement for promised goods or services to be distinct

In identifying performance obligations, ASC 606-10-25-22 addresses situations where a promised good or service is not distinct. In such situations, the guidance requires the entity to combine goods and services with other goods or services until it identifies a combination of goods or services that is distinct. To be considered distinct, the good or service must meet both of the criteria set forth in ASC 606-10-25-19, which states:

> *A good or service that is promised to a customer is distinct if both of the following criteria are met:*
>
> *a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).*
>
> *b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).*

ASC 606-10-25-20 provides additional clarification of the above and states, in part:

> *A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events.*

The various promises or services described in the QAHP agreements, when combined, generally meet the criteria set forth in ASC 606-10-25-19(a) and, consequently, together can be considered distinct. The customer can benefit from each of those promises or services when they are combined with other goods or services being transferred.

Services in the DSA are not separately identifiable

The ability to combine the promised goods or services is significant. This is because the individual promised goods or services set forth in the DSA do not independently meet the criteria for being

considered separately identifiable and distinct. They must be integrated with the promised goods or services made in the other QAHP agreements to complete development of a property that enables the QAHP to qualify for a final allocation of tax credits.

In other words, a customer could find other service providers to provide the goods or services set forth in the DSA, which primarily includes promised goods or services related to oversight of construction or rehabilitation of the property after its acquisition. However, in a QAHP revenue transaction, it is unlikely that a viable market would exist with customers willing to enter into an agreement solely for the services set forth in the DSA at the stated transaction price.

The separate goods or services set forth in the DSA impact and are therefore integral to the promised goods or services in other QAHP agreements under provisions in those agreements that clearly link performance and payment terms of the fee in the DSA to the underlying tax credits.

That linkage is frequently reflected in the provisions of the DSA, through use of provisions that require the fee paid to the DSE to be deferred and/or reduced in certain situations where doing so would be expected to be necessary to enable the QAHP to qualify for the expected amount of tax credits awarded to the QAHP in the preliminary tax credit allocation.

Step 3: Determine the transaction price

The transaction price is the fee specified in the DSA, subject to any contract adjustments contemplated in the contract with the third-party investor.

Under Topic 606, the transaction price includes all consideration to which the entity expects to be entitled in exchange for transferring promised goods or services to a customer. Such consideration may include fixed amounts, variable amounts, or both. The nature, timing, and amount of consideration promised by a customer can affect the transaction price, as described in ASC 606-10-32-3, which states:

> *When determining the transaction price, an entity shall consider the effects of all of the following:*
>
> *a. Variable consideration*
> *b. Constraining estimates of variable consideration*
> *c. The existence of a significant financing component in the contract*
> *d. Non-cash consideration*
> *e. Consideration payable to a customer*

The considerations listed above that are most likely to exist in a QAHP revenue transaction are those related to variable consideration and constraining estimates of variable consideration. In some cases, a significant financing component also may exist.

The importance of a constraint on variable consideration

Some forms of variable consideration may be present in a QAHP revenue transaction. Generally, such variables, if they exist, are connected to requirements that sufficient qualifying costs must be incurred to support the eligible basis and to perform the other requirements to qualify for the final allocation of tax credits.

Under Topic 606, an entity must estimate the amount of any variable consideration it believes it will be entitled to receive. The guidance further requires the amount of variable consideration included in the transaction price to be constrained, or limited, to an amount that is probable so that "a significant reversal in the amount of cumulative revenue recognized will not occur."[5]

The purpose of applying a constraint to variable consideration is to prevent the AHD from having to significantly reverse revenue recorded from the QAHP. At the end of each reporting period, the AHD must update the estimated transaction price from the contract "to represent faithfully the circumstances present at the end of the reporting" period and the changes in circumstances during the reporting period (ASC 606-10-32-14). At that time, the amount of any variable consideration that was constrained should be re-evaluated.

Variable consideration and constraints in QAHP revenue transactions

The most common forms of variable consideration found in QAHP revenue transactions, which may require constraints on the transaction price, include the following:

1. Contract provisions that could result in a reduction of the fixed fee in the DSA.
2. Possible deferral of payment of the fixed fee in the DSA resulting from insufficient available investment capital provided by the third-party investor, where alternative sources of payment, such as operating cash flows of the QAHP, may be insufficient and could result in nonpayment of a portion of the fixed fee amount.
3. Existence of guarantees of development costs by the AHD through the DSE or its ownership of the general partner or the managing member of the QAHP in situations where estimated total development costs are expected to be significantly more than available development sources, which could require absorption of significant unanticipated costs by the AHD.
4. Possible deferral of payment of a significant amount of the fixed fee in the DSA resulting from insufficient available investment capital provided by the third-party investor, where alternative sources of payment, such as operating cash flows of the QAHP, are expected to be sufficient; however, the expected delay in payment creates a significant financing component due to the significance of the deferred amount and the length of the expected delay in payment.

Step 4: Allocate the transaction price to the performance obligations in the contract

The fixed fee specified in the DSA, as adjusted, is allocable to the primary performance obligation with the third-party investor.

Since only one asset (the right to receive the tax credits allocated to the QAHP) is transferred to the third-party investor, all the transaction price is allocated to the performance obligation related to that asset. The fixed fee specified in the DSA, as adjusted for the impact of any variable consideration and constraints, is the transaction price.

[5] ASC 606-10-32-11

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Satisfaction of the primary performance obligation under the contract with the third-party investor occurs over time. Recognition of revenue would begin when the QAHP has performed all the following: a) Obtained a preliminary allocation of tax credits; b) obtained control of the property; and c) admitted the third-party investor to the QAHP. Satisfaction of the primary performance obligation is completed when the QAHP has submitted its application for a final allocation of tax credits with the appropriate TCA, which occurs after substantial completion of development activities.

Topic 606 requires revenue to be recognized when, or as, the entity satisfies the performance obligation, which culminates with transfer of control of the promised good or service to the customer.[6] An entity must determine at contract inception whether the performance obligations are satisfied over time or at a point in time.[7]

Satisfaction of performance obligations over time

To recognize revenue over time, at least one of the three criteria set forth in ASC 606-10-25-27 must be met. Otherwise, revenue must be recognized at a point in time. We believe fees paid to developers of QAHPs qualify for recognition over time because the AHD's performance creates and enhances the third-party investor's right to receive the tax credits allocated to the QAHP, meeting criterion "b" in ASC 606-10-25-27, which states:

> *The entity's performance creates, or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.*

Additional insight into criterion "b" is provided in the Basis for Conclusions section of ASU 2014-09 in paragraph BC129, which states:

> *The Boards included this criterion to address situations in which an entity's performance creates or enhances an asset that a customer clearly controls as the asset is created or enhanced. In those cases, because the customer controls any work in process, the customer is obtaining the benefits of the goods or services that the entity is providing and, thus, the performance obligation is satisfied over time. For example, in the case of a construction contract in which the entity is building on the customer's land, the customer generally controls any work in process arising from the entity's performance.*

Although the example referred to in the excerpt is a construction contract, we believe it provides guidance that can be applied in other situations. The promised good or service in a QAHP revenue transaction, which involves transfer of the rights to receive the tax credits allocated to the QAHP to the third-party investor, is considered similar and supports use of the criteria.

[6] ASC 606-10-25-23
[7] ASC 606-10-25-24

Method of measuring progress

When measuring progress, the objective is to reflect the entity's performance in the transfer of the promised goods or services to the customer.[8] Appropriate methods of measuring progress include output methods and input methods.[9] Additional guidance on the method used to measure progress is provided in ASC 606-10-25-32, which states, in part:

> *An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances.*

Input methods recognize revenue based on the entity's efforts or inputs to the satisfaction of the performance obligation, while output methods recognize revenue based on the value of goods or services transferred to date relative to the remaining goods or services to be transferred. When evaluating which method to use, the objective is to select one that provides the entity with a reasonable measure and a faithful depiction of progress toward complete satisfaction of the performance obligation.

Consideration of input methods

Since available input method measurements would likely be composed of costs incurred by the DSE over time, we believe such inputs would not accurately measure transfer of the rights to receive the tax credits to the third-party investor. Such costs, by themselves, do not provide the customer with access to the credits. Many of the costs incurred by the DSE are incurred before the third-party investor is admitted to the QAHP. Subsequently, additional costs incurred by the DSE do not accurately measure transfer of the asset promised under the performance obligation.

Consideration of output methods

Output method measurements would include a combination of items that would provide reasonable measures of progress toward transferring the right to receive tax credits to the third-party investor. Progress toward completion of the transfer can be measured at inception of the transaction, when the entity obtains a preliminary allocation of tax credits from the TCA; as qualifying units are constructed and delivered; and upon completion of construction and submission of an application with the TCA for a final allocation of tax credits. The above output measurements are described further below.

Output Measurement 1

The first output measurement occurs when the QAHP has obtained or accomplished all of the following:

a. The QAHP obtains an initial allocation of tax credits from the TCA.
b. The third-party investor is admitted to the QAHP.
c. The QAHP acquires the underlying real estate.

[8] ASC 606-10-25-31
[9] ASC 606-10-25-33.

These outputs are usually achieved on or before closing. An initial, or preliminary, allocation of tax credits is necessary to create the QAHP's authority to claim the tax credits being transferred to the customer. Admission of the third-party investor is necessary to achieve transfer of control over the QAHP's rights to the tax credits to the third-party investor. Acquisition of the underlying real estate is necessary to demonstrate achievement of significant initial progress toward obtaining a final allocation of tax credits.

Output Measurement 2

The second output measurement occurs as qualifying units are constructed or improved. Upon delivery, the units are available to be rented to qualifying tenants at qualified rental rates, which entitles the third-party investors to begin receiving the tax credits associated with those units. Progress toward delivery of qualifying units can be measured using either completed unit information or the amount of construction costs incurred under the construction contract.

Output Measurement 3

The third output measurement occurs when the QAHP submits its application with the TCA for a final allocation of tax credits. Achievement of this milestone indicates that the QAHP has achieved all the requirements needed to receive a final allocation of tax credits.

Amount of revenue recognition using the output measurements

Amount to be Recognized – Output Measurement 1 – The amount of progress made at this stage of the contract is difficult to measure. The guidance in paragraph 37 of ASC 606-10-25 refers to use of costs incurred that are expected to be recovered in satisfying the performance obligation. Implementation guidance provided in paragraph 18 of ASC 606-10-55 makes reference to use of rights to consideration to recognize revenue as a practical expedient. We believe either of the above could be used. Usually, the costs incurred by the DSE at this stage of the transaction are less than the entity's rights to consideration. Also, third-party investors usually fund significant amounts of their capital contribution commitment at closing and specify a partial payment of the contract amount under the DSA.

We believe an appropriate amount of revenue that could be recognized at this stage would be either the amount of unreimbursed costs incurred by the DSE expected to be recovered or the higher of the percentage of the fixed fee in the DSA payable to the DSE at closing or the percentage of the capital contribution commitment paid by the third-party investor upon its admission to the QAHP.

Amount to be Recognized – Output Measurement 2 – The amount of revenue to be recognized on a percentage-of-completion basis would be based on the total transaction price less any amounts to be recognized under the other output measurements. Progress toward delivery of qualifying units could be measured using either completed unit information or the amount of construction costs incurred by the construction contractor.

Amount to be Recognized – Output Measurement 3 – The amount of progress toward satisfying the performance obligation recognized using Output Measurement 3 should appropriately reflect achievement of any remaining activities necessary to allow the QAHP to be able to submit its application for a final allocation of tax credits with the TCA. Generally, we would expect approximately 10% of the transaction amount to be recognized upon achievement of Output Measurement 3.

The amount of progress toward satisfaction of the above output measurements should be based on the applicable portion of the transaction price, net of adjustments, if any, for variable consideration and constraints, as described in the section below.

Impact on revenue recognition of variable consideration with constraints

When variable consideration in a QAHP development fee transaction exists that could have an impact on the amount of revenue to be recognized, the AHD should adjust the amount and/or timing of revenue to be recognized, as appropriate. The amount of revenue to be recognized can be impacted when the variable consideration or constraint could result in a change in the transaction price. The timing of revenue recognition can be impacted by the existence of factors, such as the availability of QAHP operating cash flows, that make determination of the potential impact on revenue uncertain. One method of addressing the unknown impacts of such uncertainties is to defer recognition of revenue equal to the estimated potential adverse impact of any uncertainty, until the estimated impact can be reasonably determined.

Illustration of revenue recognition using output measurements

To illustrate revenue recognition by an AHD in a QAHP development fee transaction, we have provided an example below.

Facts

Total estimated development costs - $21,673,000

Total construction contract - $15,235,000

Loan proceeds - $11,000,000

Third-party investor ("TPI") capital contributions - $10,197,000

Total development fee in development services agreement - $1,800,000

Estimated deferred development fee - $476,000

Scheduled TPI contribution installments (with development fee payment amounts):

1. Closing - $2,506,776 (DSA - $446,370)
2. Completion and cost certification - $5,650,000 (DSA - $439,428)
3. Qualified occupancy and stabilization - $2,040,224 (DSA - $438,202)

Fees Paid to Developers of Qualified Affordable Housing Projects

The table below reflects the anticipated accounting recognition expected to occur at each indicated measurement event.

Event Description	Note	Payment Received	Revenue	Receivable	Deferred Liability
Receipt of TPI contribution 1 at QAHP closing		$ 446,370	$ -	$ -	$ 446,370
Achievement of Output Measurement 1 (**OM1**)	a)	-	450,000	3,630	(446,370)
Subtotal		446,370	450,000	3,630	-
Receipt of TPI contribution 2		439,428	-	(3,630)	435,798
Subtotal		885,798	450,000	-	435,798
Achievement of Output Measurement 2 (**OM2**)	b)	-	1,170,000	734,202	(435,798)
Subtotal		885,798	1,620,000	734,202	-
Receipt of TPI contribution 3		438,202	-	(438,202)	-
Subtotal		1,324,000	1,620,000	296,000	-
Achievement of Output Measurement 3 (**OM3**)	c)	-	180,000	180,000	-
Subtotal		1,324,000	1,800,000	476,000	-
Receipt of deferred development fee payments	d)	476,000	-	(476,000)	-
Total		$ 1,800,000	$ 1,800,000	$ -	$ -

Notes

a) The amount of potential revenue at achievement of **OM1** is $450,000 ($1,800,000 x 25%). The entire $450,000 is recognized as a receivable until paid. The amount of development fee recognized at achievement of **OM1** is based on the amounts of TPI contributions and related development fee payments made at the time **OM1** occurs.

b) The amount of potential revenue at achievement of **OM2** is $1,170,000 ($1,800,000 x 65%). The amount is recognized as revenue based on measured progress toward completion and delivery of qualified units using a percentage of completion based either on the number of completed units or the amount of costs incurred on the construction contract.

c) The amount of potential revenue at achievement of **OM3** is $180,000 ($1,800,000 x 10%). The entire $1,350,000 is recognized as a receivable until paid. The amount of development fee recognized at achievement of **OM2** represents the remainder of the transaction price.

d) Deferred development fee in this example is only impacted by the timing of payment.

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