Accounting for investments in real estate ventures; Exposure draft (American Institute of Certified Public Accountants), 1977, July 22

American Institute of Certified Public Accountants. Committee on Real Estate Accounting

EXPOSURE DRAFT—July 22, 1977

ACCOUNTING FOR INVESTMENTS IN REAL ESTATE VENTURES

A Proposed Recommendation to the Financial Accounting Standards Board

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EXPOSURE DRAFT

This exposure draft has been prepared for public comments by the Committee on Real Estate Accounting of the Accounting Standards Division, American Institute of Certified Public Accountants. It is being distributed to Members of Council of the AICPA; Members of Technical Executive Committees of the AICPA; State Society Presidents and Executive Directors; Chairmen of State Society Committees on Accounting Practices; and certain organizations outside the accounting profession. Copies are available to interested persons and organizations on request.

Comments should be sent in time to arrive not later than October 30, 1977 to

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To Persons and Organizations Interested
in Accounting for Investments in Real
Estate Ventures

The accompanying exposure draft has been prepared by the Committee on Real Estate Accounting of the AICPA's Accounting Standards Division to obtain the comments of interested persons and organizations. It is intended to help focus attention on the issues considered and foster the interchange of ideas among those interested in improving accounting and reporting standards.

The Committee urges respondents to give particular attention to paragraph 7 of the exposure draft. Paragraph 7 describes two alternative methods of reporting noncontrolling investors' equity in real estate general partnerships: (1) reporting the investor's equity as a single investment amount in the balance sheet; and (2) reporting separately the elements of the investment by including in current assets, noncurrent assets, current liabilities, and noncurrent liabilities the investor's equity in the partnership's corresponding items, either in total or in greater detail. Although the exposure draft does not express a preference between the two methods, it recommends the use of the same method of presentation in the balance sheet and the income statement.

The Division, however, may recommend one of the two methods in the final Statement of Position. Therefore, in commenting on this matter, respondents should indicate, and provide supporting reasons for, their preferences to assist the Division in reaching a decision.

Sincerely,

Thomas W. McRae

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Enclosure

TABLE OF CONTENTS

	Page
INTRODUCTION	1
THE APPLICABILITY OF THE EQUITY METHOD OF ACCOUNTING	2
Corporate Joint Ventures	2
General Partnerships	3
Limited Partnerships	5
Undivided Interests	6
General Matters	7
Disclosure	7
Statement of Changes in Financial Position	7
INVESTOR ACCOUNTING FOR LOSSES	7
General	7
Accounting for an Investor's Share of Losses in Excess of its Investment (Including Loans and Advances)	8
Loss in Value of an Investment (Including Loans and Advances) Which Is Other Than a Temporary Decline	10
OTHER ACCOUNTING MATTERS RELATED TO THE USE OF THE EQUITY METHOD	11
Elimination of Inter-Entity Profits and Losses	11
Accounting Principles Used by the Venture	12
Appropriate Allocation Ratios for the Determination of Investor Income	12
Accounting for a Difference Between the Carrying Amount of an Investment in a Real Estate Venture and the Underlying Equity in Net Assets	13
ACCOUNTING BY THE INVESTOR FOR CERTAIN TRANSACTIONS WITH A REAL ESTATE VENTURE	14
Capital Contributions	14
Contribution of Cash	14
Contribution of Real Estate	14
Contribution of Services or "Know-how"	15
Income from Loans or Advances to a Venture	15
Sales of Real Estate to a Venture	17
Sales of Services to a Venture	18
Purchases of Real Estate or Services from a Venture	19

Page

ACCOUNTING FOR INCOME TAXES	19
Partnerships	19
Corporate Joint Ventures	20
Different Tax and Book Bases	21
ACCOUNTING FOR THE SALE OF AN INTEREST IN A REAL ESTATE VENTURE	21

ACCOUNTING FOR INVESTMENTS IN REAL ESTATE VENTURES

INTRODUCTION

1. Ownership of real estate or real estate development projects by two or more entities may take several forms. The most common forms are described below.

   (a) A corporate joint venture - a corporation owned and operated by a small group of venturers to accomplish a mutually beneficial venture or project, as defined in paragraph 3 of APB Opinion No. 18.

   (b) A general partnership - an association in which each partner has unlimited liability.

   (c) A limited partnership - an association in which one or more general partners have unlimited liability and one or more partners have limited liability. A limited partnership is usually managed by the general partner(s), subject to limitations, if any, imposed by the partnership agreement.

   (d) An undivided interest - an ownership arrangement in which two or more parties jointly own property and title is held individually to the extent of each party's interest.

The terms "real estate venture" and "venture" when used in this Statement of Position apply to all of the ownership arrangements described above.

2. These forms of ownership differ in legal form and economic substance, and there is little authoritative accounting literature dealing with the specialized accounting problems related to such investments. These accounting problems are being dealt with in practice in a variety of ways, and the Division believes it is desirable to narrow the range of these alternative practices.

3. This Statement of Position presents the Division's recommendations on accounting for investments in real estate ventures in financial statements prepared in conformity with generally accepted accounting principles. This Statement does not apply to regulated investment companies and other entities that are required to account for investments at quoted market value or fair value.

THE APPLICABILITY OF THE EQUITY METHOD OF ACCOUNTING

Corporate Joint Ventures

4. APB Opinion No. 18 requires investments in corporate joint ventures be accounted for by the equity method and includes guidance for applying that method in the financial statements of the investor. That Opinion is applicable to corporate joint ventures created to own and/or operate real estate projects.

5. APB Opinion No. 18 states: "An entity which is a subsidiary of one of the 'joint venturers' is not a corporate joint venture." Accordingly, an entity that owns a controlling financial interest (over 50 percent of the outstanding voting shares) in a corporation is subject to accounting principles applicable to investments in subsidiaries.

Minority shareholders in subsidiaries are subject to the accounting principles applicable to investments in common stock set forth in APB Opinion No. 18 or in FASB Statement No. 12, as applicable.

General Partnerships

6. The staff of the American Institute of Certified Public Accountants issued an interpretation of APB Opinion No. 18 in November, 1971, which concludes that many of the provisions of APB Opinion No. 18 would be appropriate in accounting for investments in certain unincorporated entities. The Division believes that the principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that the individual investors in general partnerships usually assume "joint and several liability." In most instances, however, there is an expectation that the assets of a general partnership will be capable of satisfying the partnership's liabilities. Furthermore, investors in real estate partnerships with significant nonrecourse loans secured by real estate assets may be in substantially the same position as if they were investors in corporate joint ventures. Accordingly, the Division believes that investments in real estate general partnerships should be accounted for and reported under the equity method. Reference should be made to paragraph 19 of APB Opinion No. 18 for guidance in applying the equity method.

7. In applying the equity method to investments in real estate general partnerships, some investors present a single net investment amount (asset or liability) in their balance sheets, which is the reporting format required for investments in corporate joint ventures. Others

draw a distinction between the application of the equity method to investments in general partnerships and corporations and set forth separately the elements of the investment in general partnerships by including under current assets, current liabilities, noncurrent assets, and long-term debt their equity in the investee's corresponding items, either in total or in greater detail. The Division believes that if the elements of the investment are set forth separately in the investor's balance sheet, the investor's statement of income should now present under revenues and under costs and expenses the investor's equity in the investee's corresponding items, instead of presenting a single amount for its equity in the investee's income before extraordinary items. Similarly, the Division also believes that if the investor's equity in revenues and its equity in expenses are reported separately (in total or in greater detail) in the investor's statement of income, each element of the investment should now be presented separately in the investor's balance sheet. Each element presented separately in the investor's financial statements should be clearly described as representing the investor's equity in the investee's corresponding items.

8. A general partnership that has an investor who owns a controlling financial interest (over 50 percent) is, in substance, a subsidiary of that investor. Accordingly, the Division believes that the controlling investor should account for its investment under the principles of accounting applicable to investments in subsidiaries (see paragraph 5). The minority investors in a subsidiary of another investor should account for their investments by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion No. 18 and the recommendations

in paragraph 7 above.

Limited Partnerships

9. The Division believes that the accounting recommendations for investments in corporate joint ventures are generally applicable to accounting by limited partners for their investments in limited partnerships, because of the limitation on their responsibility for partnership liabilities.

10. The rights and obligations of the general partners in a limited partnership are different from those of the limited partners. Some believe that general partners should be deemed to have the controlling interest in a limited partnership. However, limited partners often have important rights, such as the right to replace the general partner(s), approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets, which may indicate that the general partnership interests are not the controlling financial interests. Accordingly, the Division believes that a general partner holding a financial interest of more than 50 percent of the general partnership interest should be guided in accounting for his investment by the principles applicable to investments in subsidiaries only when the partnership agreement provides for control by the general partner(s). In all other cases, a general partner in a limited partnership should account for its investment by the equity method, and should be guided by the provisions of paragraph 19 of APB Opinion No. 18 and the recommendations in paragraph 7 above.

11. Similarly, the Division believes that when the substance of the partnership arrangement is such that the limited partners control the

partnership (situations in which the limited partners have rights of the type discussed in paragraph 10 may be indicative of control), a limited partner holding a financial interest of more than 50 percent of the limited partnership interests should be guided in accounting for his investment by the principles applicable to investments in subsidiaries. The minority investors, including the general partners, should account for their investment by the equity method and should be guided by the provisions of paragraph 19 of APB Opinion No. 18 and the recommendations in paragraph 7 above.

Undivided Interests

12. Occasionally, real property is jointly owned and operated as undivided interests in assets, rather than by a separate entity such as a corporate joint venture or a partnership. Under such an ownership arrangement, each investor may separately encumber its own undivided interest in the property. When liabilities associated with property owned through undivided interests are several in nature (i.e., when each investor is liable only for its liabilities and its creditors have no claim or lien on the property in excess of the investor's interest therein), the Division believes the investor should account for and report its undivided interest in the assets and its liabilities, revenues and expenses attributable to the undivided interest. However, if creditor(s) have a claim or lien on the assets as a whole, the Division believes that there are no significant differences between such ownership interests and those in a general partnership, and the investment should be accounting for and reported on using the recommendations applicable to general partnerships.

General Matters

Disclosure

13. The Division believes that investors in real estate ventures should be guided by the provisions of paragraph 20 of APB Opinion No. 18 and of paragraph 7 of this Statement in determining the disclosures made in their financial statements.

Statement of Changes in Financial Position

14. APB Opinion No. 19, which governs the form and content of statements of changes in financial position, requires, among other things, disclosure of working capital or cash provided from operations. The investor's share of a real estate venture's earnings reported under the equity method, to the extent that such earnings are not distributed in the period earned, should not be included in the amount reported as working capital or cash provided by operations, except to the extent the elements of the investment are set forth separately as described in paragraph 7 or to the extent an undivided interest is presented in the manner described in the next to the last sentence of paragraph 12.

INVESTOR ACCOUNTING FOR LOSSES

General

15. Some investors have suggested that their equity in losses of a real estate venture need not be recorded when the equity method of accounting is followed as long as there has been no impairment of the value of their investment; for example, when it is expected that the venture's assets can be sold for more than their carrying value. The

Division believes that it is not appropriate for investors to reduce their share of a real estate venture's losses, determined in conformity with generally accepted acounting principles, by unrealized increases in the estimated fair value of the venture's assets. However, the Division believes that the fair value of the venture's assets may be used to evaluate the ability and willingness of the other investors to bear their share of losses.[1]

Accounting for an Investor's Share of Losses in Excess of Its Investment (Including Loans and Advances)

16. The Division believes that an investor should record its equity in real estate venture losses in excess of its investment (including loans and advances) when the investor is liable for the obligations of the venture or is otherwise committed to provide additional financial support to the venture. Examples of such circumstances include the following:

(a) The investor has a legal obligation as a guarantor or general partner.

(b) The investor has a commitment based on consideration of business reputation, intercompany relationships, credit standing, etc. Such a commitment might be evidenced by:

(i) Previous support by the investor indicating that the venture obligations would be dis-

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1 An investor in an undivided interest may not be able to use the fair value of the other investor's interests in the venture's assets to evaluate the ability and willingness of the other investors to bear their share of losses because the extent to which the interests of other investors are encumbered by liens may not be known.

charged by the investor.

(ii) Public statements by the investor of its intention to provide support.

(iii) Operating considerations, such as losses from a material nonrecurring event or transaction or from start-up costs which are believed to be offset by unrealized appreciation in value. (See footnote 10, APB Opinion No. 18.)

17. An investor in a real estate venture should ordinarily report its recorded share of losses in excess of its investment (including loans and advances) as a net liability in its financial statements, unless the elements of the investment are separately presented as discussed in paragraph 7.

18. When an investor does not recognize venture losses in excess of its investment and the venture subsequently reports net income, the investor should resume applying the equity method only after its share of such net income equals the share of net losses not recognized during ther period in which equity accounting was suspended.

19. If one or more investors are not capable of bearing their share of losses, the remaining investors should record their proportionate share thereof.[2] (The Division believes that an investor who is deemed by other investors to be not capable of bearing its share of any losses should continue to record its contractual share of such losses unless

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[2]This recommendation does not apply when real property is jointly owned and operated as undivided interests in assets if the claims or liens of the investor's creditors are limited to the investors' respective interests in such property.

it is relieved from the obligation to make payment by agreement or operation of law.) When the venture subsequently reports income, those remaining investors should record their proportionate share of the venture's net income otherwise allocable to the investor deemed to be not capable of bearing its share of losses until such income equals the excess losses previously recorded by them.

20. The Division believes that, as a general rule, each investor should look primarily to the current value of the other investors' interests in the venture in evaluating their ability and willingness to bear their allocable shares of losses.[3] However, there may be satisfactory alternative evidence of an ability and willingness of other investors to bear losses, such as when other investors have made previous loans or contributions to support cash deficits, possess satisfactory financial standing (such as evidenced by intermediate or long-term debt of such other investors that bears satisfactory credit rating) or have provided collateralized guarantees.

Loss in Value of an Investment (Including Loans and Advances) Which Is Other Than a Temporary Decline

21. A loss in value of an investment (including loans and advances) which is other than a temporary decline should be recognized the same as a loss in value of other long-term assets. Such a loss in value could be indicated, for example, by a decision by any of the investors to cease providing support or to seek to revise relationships with the other investors.

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[3] An investor may not be able to apply the general rule to an investment in an undivided interest because the extent to which the interests of other investors are encumbered by liens may not be known.

OTHER ACCOUNTING MATTERS RELATED TO THE USE OF THE EQUITY METHOD

Elimination of Inter-Entity Profits and Losses

22. As noted elsewhere in this Statement, reference should be made to APB Opinion No. 18 for guidance in applying the equity method. Paragraph 19(a) of that Opinion provides that, in applying the equity method, intercompany profits and losses should be eliminated until realized by the investor or investee as if the investee company were consolidated. An AICPA Accounting Interpretation which clarified this provision states that intercompany profit should be eliminated by the investor in relation to the investor's ownership interest in the investee, except that when an investor controls the investee through majority voting interest and enters into a transaction with the investee which is not on an "arm's-length" basis, or when an investee is established with the cooperation of an investor and control is exercised through guarantees of indebtedness, extension of credit, etc., none of the intercompany profit or loss should be recognized in income by the investor until it has been realized thorugh transactions with third parties.

23. The AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate, also sets out similar rules in paragraph 58, as follows:

> A sale of property in which the seller holds or acquires an equity interest in the buyer should result in recognizing only the part of the profit proportionate to the outside interest in the buyer. No profit should be recognized if the seller controls the buyer...until realized from transactions with outside parties through sale or operations of the property.

24. The Division believes that if a transaction with a real estate venture indicates that there has been a loss in the value of the asset sold, which is other than temporary and that had not been

recognized previously, such a loss should be recognized on the books of the transferor.

Accounting Principles Used by the Venture

25. In the real estate industry, a venture may use accounting practices, such as those for the purpose of preparing tax-basis data for investors, which are at variance from generally accepted accounting principles. If the financial statements of the investor are to be prepared in conformity with generally accepted accounting principles, it would be necessary in applying the equity method to eliminate any such material variance. In addition, it is desirable for each investor, if practicable, to adjust its equity in the income or loss of the venture to conform to the accounting principles and policies used by the investor in accounting for its own real estate activities.

Appropriate Allocation Ratios for the Determination of Investor Income

26. Venture agreements may designate different allocations among the investors of the venture's (a) profits and losses, (b) specified costs and expenses of revenues, (c) distributions of cash from operations, and (d) distributions of cash proceeds from liquidation. Such agreements may also provide for changes in the allocations at specified times or upon the occurrence of specified events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph 20. The Division believes that in order to determine the investor's share of venture net income or loss, such agreements or arrangements should be analyzed to determine how an increase or decrease in net assets of the

venture (determined in conformity with generally accepted accounting principles) will ultimately affect cash payments to the investor, whether over the life of the venture or upon its liquidation. The Division believes it is not appropriate to utilize specified profit and loss allocation ratios to determine an investor's equity in venture earnings when the allocation of cash distributions is determined on some other basis, or when liquidating distributions will not be based on the venturers' capital accounts adjusted for all previous profits and losses. For example, if the investors will ultimately share equally in any loss of value of the property, depreciation expense should be allocated equally to each investor, notwithstanding any provisions of the agreement to the contrary.

Accounting for a Difference Between the Carrying Amount of an Investment in a Real Estate Venture and the Underlying Equity in Net Assets

27. Differences between the carrying amount of an investment in a real estate venture and the investor's equity in the underlying net assets recorded by the venture may arise from nonrecognition of profit on contributions or sales of real estate to the venture and differences in income recognition or in other accounting methods. In addition, differences may arise from the acquisition of an investment in a venture at a price different from the share of the net assets acquired as recorded on the books of the venture.

28. Paragraph 19(b) of APB Opinion No. 18 provides that the difference between the cost of an investment and the amount of the underlying equity in net assets of the investee "should be accounted for as if the investee were a consolidated subsidiary."

29. When the difference arises from a business combination accounted for as a purchase, it should be accounted for in accordance with the provisions of APB Opinion No. 16. The Division believes that, in most cases, an excess of the cost of the investment acquired over the equity in the underlying net assets would not be ascribed to goodwill because of the limited life and limited purpose usually inherent in real estate ventures.

30. The differences associated with the real property owned by the venture should be recognized as an adjustment to depreciation, cost of sales, or other expenses in recording income or loss from the venture on the equity basis.

ACCOUNTING BY THE INVESTOR FOR CERTAIN TRANSACTIONS WITH A REAL ESTATE VENTURE

Capital Contributions

Contribution of Cash

31. When all investors contribute cash at the formation of the joint venture or partnership, each investor should record its investment at the amount of the cash contributed.

Contribution of Real Estate

32. The Division believes that, as a general rule, when an investor contributes real estate to the capital of a real estate joint venture or partnership, the investor should record its investment at the cost (less related allowances for depreciation or loss in value) of the real estate contributed, whether the other investors contribute cash, other property, or services. The Division believes that it is not appropriate for an investor to recognize profit on a transaction

that has the economic substance of a contribution to the capital of an entity and is not the culmination of the earnings process. The Division recognizes, however, that some transactions structured in the form of a capital contribution may in economic substance be a sale transaction, as to which the recommendations in this Statement with respect to investor accounting for sales transactions would apply.

33. An investor contributing property to a venture may obtain a disproportionately small interest in the venture based on a comparison of the cost or carrying amount of the property to the cash contributed by the other investors. This might indicate that the investor contributing the property has suffered a loss that should be recorded under the general principle that all losses should be recognized when they are probable and can be reasonably estimated.

Contribution of Services or "Know-how"

34. The Division believes the accounting considerations that apply to real property contributed to a partnership or joint venture also apply to contributions of services or "know-how."

Income from Loans or Advances to a Venture

35. When an investor makes interest-bearing loans or advances to a venture, the entire interest income accrued thereon should be recorded as earned if (a) the interest has been recorded as an expense by the venture or (b) the investor has adjusted its equity in the income or loss of the venture to expense such interest, following the recommendations in paragraph 25. It should be noted that an evaluation similar to that discussed in paragraph 19 and 20 for recording the investor's share

of losses should be made, however, to avoid recording as interest income amounts which may ultimately be borne as losses by the investor making the loan.

36. When conditions (a) or (b) in the previous paragraph are not present, then interest income should be deferred as follows. In the absence of any of the conditions listed below, interest income should be deferred to the extent of the lender's equity interest in the venture. When any of the the conditions listed below are present, all interest income on the investor's loans should be deferred. The conditions referred to above are as follows:

(a) Collectibility of the principal and interest is in doubt, which may exist if adequate collateral and other terms normally required by an independent lender are not present.

(b) Each investor is required to make loans and advances proportionate to its equity interests, the substance of which would constitute capital contributions.

(c) There is a reasonable expectation that the other investors will not bear their share of any losses, resulting in uncertainty as to the lender's share of the venture's operating results.

Sales of Real Estate to a Venture

37. When real estate is sold to a real estate venture by an investor, the Division believes that profit recognition to the extent of other investors' proportionate interests in the venture is appropriate if all necessary conditions for profit recognition set forth in the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate, are satisfied. The Guide sets out criteria for (a) minimum cash down payments ranging from 5 percent to 25 percent of sales value, depending on the type of property involved, (b) annual payments on the resulting receivable over an appropriate period, and (c) deferral of all or part of the profit under certain circumstances, including those in which the seller continues to be involved with the property. Examples of continuing involvement by the seller/investor include circumstances in which the seller:

(a) Is required to support the property, its operations, or related obligations to an extent greater than his proportionate interest in the venture.

(b) Has granted preferences as to profits or cash flow to the other investors.

(c) Is a general partner in a limited partnership holding the property and holds a significant receivable related to the property ("significant" being defined as a receivable in excess of 15 percent of the maximum first lien financing available).

(d) Is required to support operations (in the form of guarantees, leaseback arrangements, etc.).

(e) Is otherwise presumed to be obligated to support operations (such as when the investor is a general partner in a limited partnership holding the property).

(f) Is responsible for managing, developing or constructing improvements on the property.

(g) Has an option or obligation to repurchase the property.

(h) Is required to arrange or provide financing for the project.

38. This Statement of Position only deals with special problems unique to investors in real estate ventures. It does not supersede or amend any section of the Guide. In any sale of real estate, attention should be given to <u>all</u> of the provisions of the Guide.

Sales of Services to a Venture

39. When services are performed for a venture by an investor and the cost of such services is capitalized by the venture, profit recognition based on performance may be appropriate to the extent attributable to the outside interests in the venture if the following conditions are met:

(a) The substance of the transaction is not significantly different from its form.

(b) There are no substantial uncertainties as to the ability of the investor to complete performance (such as may be the case if the investor lacks experience in the business of the venture) or as to the total cost of services to be rendered.

(c) There is a reasonable expectation that the other investors will bear their share of losses, if any.

Purchases of Real Estate or Services from a Venture

40. An investor should not record in income its equity in the venture's profit from a sale of real estate to that investor; the investor's share of such profit should be recorded as a reduction in the carrying amount of the purchased asset and recognized in income on a pro rata basis as the asset is depreciated or when the asset is sold to a third party. Similarly, if a venture performs services for an investor and the cost of those services is capitalized by the investor, the investor's share of the venture's profit in the transaction should be recorded as a reduction in the carrying amount of the capitalized cost.

ACCOUNTING FOR INCOME TAXES

Partnerships

41. Ordinarily a partnership is not directly subject to federal, state, or city income taxes. Taxable income or loss from its operations is included in the taxable income of the investors. Therefore, each investor should provide for taxes on its equity in the profits of a partnership. Timing differences should be accounted for in accordance with the provisions of APB Opinion No. 11.

Corporate Joint Ventures

42. An investor's equity in the undistributed earnings of a corporate joint venture represents a timing difference, since income reported currently in the investor's financial statements is not taxable until it is received as a dividend or realized by a sale of the investor's interest in the venture. The investor must determine whether to record income taxes that would have been payable had such earnings been currently distributed in a taxable transaction in the same period the earnings are recorded. APB Opinion No. 23, Accounting for Income Taxes -- Special Areas, provides guidance in this area.

43. APB Opinion No. 23 states that deferred taxes should be provided on undistributed venture earnings at the time the investor records in income its equity in the venture's earnings if the corporate joint venture's life is limited by the nature of the venture, project, or other business activity. In such cases, the Opinion notes, it can reasonably be presumed that the earnings of the venture will be transferred to the investor in a taxable distribution.

44. If the corporate joint venture is essentially permanent in duration, then an analysis must be made to determine:

(a) The portion of the venture's earnings that evidence demonstrates will be invested indefinitely in the venture, or that will be remitted in a tax-free liquidation, in which case deferred taxes should not be provided.

(b) The remaining portion, presumed to be transferred to the investor in a taxable transaction, for which deferred taxes should be provided.

45. The investor should provide for deferred taxes by computing the additional income taxes (at normal rates allowing for foreign tax credits or dividend-received deductions, if applicable, or at capital gains rates, whichever is appropriate) that would have been payable, assuming that the earnings were distributed as a dividend or the investments were sold in the current period, and assuming further that the investor utilized all available tax-planning alternatives and available tax credits and deductions.

Different Tax and Book Bases

46. Appropriate income tax allocation principles should also be utilized to account for timing differences that cause differences in the tax and book bases of the investment.

ACCOUNTING FOR THE SALE OF AN INTEREST IN A REAL ESTATE VENTURE

47. Sales by an investor of its investment in a real estate venture result in gains or losses in the amount of the difference between the selling price and the carrying amount of the portion of the investment sold. Deferred taxes related to timing differences should be given accounting recognition.

48. The Division believes that a sale of an investment in a real estate venture (including the sale of stock in a corporate real estate joint venture) is the equivalent of a sale of an interest in the

underlying real estate and should be evaluated under the guidelines set forth in the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate.

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