IMPAIRMENT FOR LOW INCOME HOUSING TAX CREDIT PROPERTIES

Presented by CohnReznick LLP

Overview

I. ASC 360 (formerly SFAS 144): Accounting for the Impairment or Disposal of Long-Lived Assets

II. Special Considerations: Low Income Housing Tax Credit (LIHTC) Properties

III. Sample Impairment Calculation
I. ASC 360 (formerly SFAS 144)

• The Impairment Concept
  o Impairment is a condition that exists when the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. An impairment loss shall be recognized only if the carrying amount of the asset is not recoverable and exceeds fair value.
  o The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset.
  o An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value.
  o If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset becomes its new cost basis.
  o Restoration of a previously recognized impairment loss is prohibited.

I. ASC 360 (formerly SFAS 144) (continued)

• Steps in identifying, recognizing and measuring impairment of a long-lived asset:
  o Step 1 Indicators of impairment: Consider whether indicators of impairment are present.
  o Step 2 Test for recoverability: If indicators are present, perform a recoverability test by comparing the sum of the estimated undiscounted future cash flows attributable to the asset in question to their carrying amounts.
  o Step 3 Measuring the impairment: If the undiscounted cash flows used in the test for recoverability are less than the long-lived asset’s carrying amount, determine the fair value of the long-lived asset and recognize an impairment loss if the carrying amount of the long-lived asset exceeds its fair value.
I. ASC 360 (formerly SFAS 144) (continued)

• Step 1 Indicators of impairment:
  o A long-lived asset should be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the long-lived asset might not be recoverable. The following are examples of impairment indicators:
    ➢ Significant adverse change in extent or manner in which asset is being used or in its physical condition
    ➢ Significant adverse change in legal factors or in the business climate that could affect recoverability
    ➢ Accumulation of costs significantly in excess of the amount of originally expected for the acquisition or construction of the asset
    ➢ Current period operating or cash flow loss combined with a history of such losses or a projection that demonstrates continuing losses associated with the use of the asset

• Step 1 Indicators of impairment (continued):
  ➢ Expectation that the asset will be sold or otherwise disposed of significantly before the end of its estimated useful life
  o The following are examples of false impairment indicators:
    ➢ Recent decrease in revenue due to unusual circumstances
    ➢ Recent increase in maintenance expenses
    ➢ Recent increase in repairs expense funded from replacement reserves
    ➢ Recent increase in insurance expense due to a natural disasters for which government assistance is anticipated
    ➢ Existence of operating losses for which the Partnership agreement provides for operating reserves that have been or will be funded by the Partners, to cover such losses
I. ASC 360 (formerly SFAS 144) (continued)

• Step 2 Test for recoverability:
  o If impairment indicators are present, management must determine whether an impairment loss should be recognized. An impairment loss is to be recognized for a long-lived asset if the sum of its estimated future undiscounted cash flows is less than its carrying amount. A long-lived asset’s carrying amount is generally computed as follows:
     Historical cost basis
     Minus: Accumulated depreciation
     Minus: Previously unrecovered amounts (i.e. unamortized tax credit equity)
  o Estimated future cash flows should include only future cash flows that are directly associated with the asset and that are expected to arise as a direct result of its use and eventual disposition, derived through the end of the asset’s remaining useful life.

• Step 2 Test for recoverability (continued):
  o If estimated undiscounted cash flows, that are directly associated with the long-lived asset, are less than the asset’s carrying amount, the asset is deemed unrecoverable; therefore its fair value should be determined. Undiscounted cash flows are generally computed as follows:
     Projected Net Operating Income (NOI) (NOI x Remaining Useful Life)
     Plus: Estimated residual value of the long-lived asset (based upon audit evidence), upon its eventual disposition or at the end of its useful life
     Plus(minus): Adjustments for non-recurring items (both positive and negative), including refurbishment expenditures necessary for the asset to maintain its operating potential
I. ASC 360 (formerly SFAS 144) (continued)

• Step 3 Measuring impairment
  o If the undiscounted cash flows, used in Step 2, are less than the long-lived asset’s carrying amount, its fair value must be determined.
  o If the long-lived asset’s carrying amount exceeds its fair value an impairment loss must be recognized. An impairment loss is to be allocated to assets within a long-lived asset group on a pro-rata basis using their relative carrying amounts. The carrying amount of a long-lived asset group should not be reduced below its fair value.

II. Special Considerations: LIHTC Properties

• Impairment Analysis
  o A LIHTC property is generally expected to be less profitable in terms of financial performance, as compared to a market rate property due to the fact that the LIHTC property is rent restricted. Such rent restrictions are agreed to by the entity in exchange for receiving an allocation of tax credits from the government, which are then sold to investors. The resulting capital is used to partially finance construction of the property. The portion of construction costs that was not funded with investor capital, must be recovered through the property’s operations. In situations where recovery of the long-lived asset’s carrying amount through the property’s operations, is not expected, the result is an impairment charge. Alternatively, when the financial performance of the property is positive or at least sufficient to allow for recovery of the asset’s carrying amount net of funded investor capital, then the long-lived asset is not considered to be impaired.
II. Special Considerations: LIHTC Properties (continued)

• Fair Value

  o LIHTC properties are unique assets with respect to fair value measurement. They are seldom sold in a fee simple transaction due to the existence of various legal and contractual restrictions. Furthermore, because of the unique and diverse attributes of the owner’s (GP) interest and the investor’s (LP) interests, the combined interests of the two ownership groups are seldom sold in one transaction. Rather, GP interests and LP interests are usually sold individually. Accordingly, market participant data and comparable fee simple transactions are difficult to obtain, even under good economic conditions. This requires that fair value measurement is based, to a large degree, on unobservable inputs and management assumptions rather than on direct market data.

II. Special Considerations: LIHTC Properties (continued)

• Calculation of Fair Value

  o The following are additional consideration when measuring the fair value of a LIHTC property:

    ➢ Value of cash flow
    ➢ Value of remaining tax credits
    ➢ Value of remaining tax deductions

  o The determination of fair value, of a LIHTC property, is often accomplished in the following manners:

    ➢ Appraisal from independent third party
    ➢ Internal fair value computation performed by management
III. Sample Impairment Calculation

- Assumptions
  - Fair value of the long-lived assets: $4,100,000
  - Impairment: $1,600,000.
  - The adjusted carrying amount of the long-lived assets represents their new cost basis and should be depreciated over remaining useful life. The impairment charge is allocated pro rata among each asset group based on their individual carrying amounts.

<table>
<thead>
<tr>
<th>Asset Type</th>
<th>Unadjusted Basis at 12/31/XX</th>
<th>Pro Rata Impairment Allocation</th>
<th>Adjusted Basis at 12/31/XX</th>
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<tbody>
<tr>
<td>Land</td>
<td>$500,000</td>
<td>$(140,351)</td>
<td>$359,649</td>
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<tr>
<td>Land improvements</td>
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<td>(66,604)</td>
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<td>FFE</td>
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<td>Accumulated depreciation</td>
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<td>6,000,000</td>
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</tr>
</tbody>
</table>

Net carrying amount of assets: $5,700,000 $ (1,600,000) $ 4,100,000

Fair value: $4,100,000 $4,100,000

Impairment - excess of remaining net investment over fair value: $(1,600,000)