So You Want to Be a LIHTC Developer: Four Factors to Meet the 50% Test and 95-5 Test for Private-Activity Bond Transactions

Affordable housing professionals who use the 4% low-income housing tax credit to finance and build homes may be familiar with two key tests that are crucial to bond transactions: The 50% test and the 95-5 test. On this week’s episode of Tax Credit Tuesday, Michael Novogradac, CPA, and Charlie Rhuda, CPA, unpack four essential pieces of information about each of these two tests. First, they give background on each of the tests before discussing issues of timing and application. Then, the two discuss the consequences of failing the test and then suggest ways to overcome those obstacles.

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Introduction

[00:00:11] Michael Novogradac, CPA: Hello, I'm Michael Novogradac, and this is Tax Credit Tuesday. This is the Aug. 15, 2023, podcast. I am coming to you from Hiroshima, Japan. I'm taking a break from my vacation with my children to bring you this podcast.

With that, let me welcome you to another exciting episode in our So You Want to Be a LIHTC Developer series. As the name implies, this series is intended to help real estate developers learn more about building, renovating and operating affordable rental housing using the low-income housing tax credit.

The low-income housing tax credit is the most successful federal incentive used to build and renovate affordable rental housing. Simply put, affordable rental housing is not financially viable without subsidizing either acquisition and development costs or annual rental income and cash expenses. And the low-income housing tax credit serves to help subsidize acquisition and development costs.

Now, there are two ways for developers to access the low-income housing tax credits. First, there's the 9% allocated credit. The 9% credit is available for both new construction and substantial rehabilitation costs. It is also available for acquisition of an existing building, but in that case, the acquisition credit is available at a reduced rate of 4%. Now the second credit is often referred to as the 4% credit, and it's generally available if project costs are financed in part by tax-exempt, private-activity bonds.

Now, in order to issue such bonds, the lender must apply for and receive the right to issue such private-activity bonds. Each state in possession of the United States has a limited authority as to the amount of private-activity bonds that they can issue. This is often referred to as their, and I quote, "volume cap," unquote.

Now, the 4% volume cap credit can be used to finance new construction, the acquisition costs of an existing building, and the renovation costs of an existing building. These transactions are often referred to as "bond deals" because they're being financed with taxes and bonds.

Now, if you'd like to learn more about the two types of credits, I do invite you to check out a podcast episode that we did comparing 9% and 4% low-income housing tax credit transactions. We recorded the podcast back in May of 2022, and I will include a link to that episode in our show notes.

Now, in today's podcast, we're going to discuss the two tests that are crucial to bond deals. Now, these two tests are the 50% test and the 95%/5% test. Today's episode will describe the basics of these two tests. We'll discuss when the tests are measured and what goes into each calculation. We'll also take a more in-depth look at the consequences of failing the tests, and we'll discuss some strategies to ensure that the tests are satisfied.
Now, before introducing today's guest, I first want to share that in about a month, Novogradac is hosting a conference that's focused on the acquisition, development, and operation of low-income housing tax credit properties. Our Housing Tax Credit and Bonds Conference will be held September 28 and 29 in New Orleans. This conference is a great opportunity to learn more about the topics we're discussing in today's episode, as well as to dig deeper into a variety of related subjects. The conference is also a great opportunity to network with tax credit syndicators, lenders, and other developers.

And if you do attend, please take a moment to introduce yourself to me, as I will be there as well. For yet more information about the 4% volume cap credit, listeners can join our Low-Income Housing Tax Credit Working Group. This group meets monthly via Zoom, and I'll include information about joining in today's show notes.

And lastly, we have a bit more, Novogradac is hosting a webinar this Thursday, from 1 to 3 p.m. Eastern Time. The webinar will focus on private-activity bonds and the 4% credit. This webinar is available and can be accessed through our website at novoco.com and the webinar will include an overview of the two tests we're discussing today and we'll delve into this subject matter in greater depth if. Now, let me introduce my guest.

Joining us today is my partner, Charlie Rhuda. Charlie is based at Novogradac's Boston office. Charlie has more than three decades of experience in the real estate industry, predominantly in affordable housing, community development, and historic preservation. Some of you may recognize Charlie as a speaker at regional and national tax credit conferences, including some of our own Novogradac conferences. Charlie has also moderated webinars on today's topics, which makes him a great guest for today's discussion.

This episode does mark Charlie's first appearance on Tax Credit Tuesday. I'm not sure why he hasn't been on before but we do have a lot to cover today. So if you're ready, let's get started.

So Charlie, welcome to Tax Credit Tuesday.

[00:05:12] Charlie Rhuda, CPA: Thanks, Mike. Looking forward to it.

[00:05:14] Michael Novogradac, CPA: Now I'm excited to have you on the first of many appearances on Tax Credit Tuesday. So let's begin the discussion with the 50% test, and then we'll move into the 95%/5% test. And for each of these two tests, I'd like to separate our discussion into four key areas. First, I'd like for you to be able to discuss and explain the basic test.

Secondly, I'd like you to review when the tests are typically measured, and then from there, I'd like to discuss the consequences of failing the tests, and then fourth, suggest some ways to overcome obstacles to satisfying the tests. So with that background, talk about 50% tests first, then 95%/5%, and move into these four areas. Is there anything else you want to add to that overview?
Charlie Rhuda, CPA: No, I think that sounds good, and we'll be discussing all of that in more detail.

50% Test Overview

Michael Novogradac, CPA: So thank you for that. So with that framing, let’s start with the 50% test, and if you could explain to our listeners at a fairly high level what the 50% test is.

Charlie Rhuda, CPA: So, the 50% test requires that greater than 50% of a development’s aggregate basis, which we’ll define soon, must be financed by the tax-exempt, private-activity bonds in order for you to be able to receive the as-of-right tax credits. For purposes of the 50% test, the notion of aggregate basis is a little bit different from the definition of eligible basis that we’ve come to know and understand and is found in Internal Revenue Code Section 42D. The eligible basis is the amount on which the maximum LIHTC is calculated, which is essentially the building’s adjusted basis for federal income tax purposes, right?

And so this can include personal properties such as furniture and fixtures. So, there is a private letter ruling that the IRS issued that addresses the term aggregate basis. And it essentially says sort of in a roundabout way that aggregate basis is not limited to Section 1250 property. For those of us who are not tax geeks, 1250 property is depreciable property, long lived, generally your building a residential or commercial but it also includes other, all property, including Section 1245 property and depreciable land improvements. And again, Section 1245 property is a new depreciable property that is a 1250 property. So, you know, we always love reading the tax code and understanding how they get to all these. Essentially, the 1245 property is going to be things like your furniture and fixtures, appliances and subsidy, putting in the units in a multifamily in a multifamily rental. So just to sort of wrap that up, we like to say aggregate basis is commonly described as the land plus the depreciable basis.

So moving along, so if the 50% test is passed, right, then you get 4% tax credits as of right, and you get to claim that on 100% of your eligible basis cost. If the project does not pass the 50% test, then only that portion financed by the bonds can be used in the tax credit calculation. And I’m going to give a, I’m going to give a brief example. And again, this would be one of the things on Thursday’s webinars that we’ll be delving into in in much greater detail.

So let’s assume that we have an eligible basis, an eligible basis of $100 and we pass the 50% test. Then the project is going to qualify for $40 worth of tax credits. So that’s 100%, 100 times 4% over 10 years, right? And if a hypothetical tax credit investor is willing to pay a dollar for the credits, right? A dollar makes the math easy. Then the investor would contribute $40 worth of tax credit equity towards your $100 in eligible basis.

If the 50% test were to come in at 49%, then you’re only going to have $19.60 worth of tax credits. And that’s $49 times 4% times 10 years, right? It’s a 51% reduction in credits and equity. And even though...
there are still tax credits, the resulting reduction of $21.60 means that your project is not going to be likely to be financially feasible. It's going to leave a very large gap. And again, as I said, we'll delve into this calculation much more on, on Thursday's webinar.

So in order to be eligible for these as-of-right bond credits, the bonds must be a meaningful source of financing. And generally that's, that's 50%. It's in the code right now. Many years ago, that number used to be 70% and we're hoping that that number may come down in future legislation.

So, as Mike mentioned earlier, tax credits for bond transactions are not allocated like the 9% credit. The developer will apply for an allocation of the state's tax-exempt private activity volume cap, which will give them the ability to use the bonds to finance either the acquisition, renovation, or new construction. Each state has a different application and allocation process, and depending on the state that you're in, this may or may not be a competitive process. Many states, and I want to say it was more than 20 at my last count, now have greater demand for their volume cap allocation than they have allocation to grant. And so and so those states are working hard to spread their allocation to get as many deals as possible done.

And I would just add, like many things in the development process, you need to know your state and be comfortable with your state's qualified allocation plan and how they how they plan to use their subsidies, both the tax credits and the bonds.

[00:11:11] **Michael Novogradac, CPA:** So, thank you for that, Charlie. That was pretty thorough. And I know that you'll agree when I say there's a lot of simplifications in what you were sharing so for listeners, just know that there was a, that it's not as simple as Charlie described it. You know, for example, when we were doing the eligible basis calculations, you know, you only get to claim tax credits on your qualified basis, and that's your eligible basis times your low-income occupancy percentage.

So if it was a mixed use transaction, the rest, the numbers would change. And then there's issues about how you trace the money into different costs. And if you were to fall below the 50% test, there's a number of variations there. Then also when it comes to applying for private-activity, applying for private-activity bond cap generally the issuer of the bonds does the application process, so a developer will work with an issuer of the bonds if the issuer of the bonds has to apply. So like California bond issuers will apply for the right to issue these credits, and a developer will then reach out to that issuer to issue the bonds for their project. In other states, there's a state, state housing agency that has the right to issue the bonds.

So it varies across the states. So once again, there's a lot of simplifications and what Charlie was describing, you know, for purpose of this podcast, we have to simplify. So I wasn't sure if you had anything else you wanted to add to that, Charlie, or we can move on to the basics of the calculation.
[00:12:44] Charlie Rhuda, CPA: No, actually, what I'll just add is the last thing I said: Like everything else in the development process, you need to know the state that you're working in, and you need to understand how they how you can apply for all of these resources.

[00:12:56] Michael Novogradac, CPA: So, thank you for that. Now, let's get, we are accountants, so let's not get too much into the details, but we'll get a little bit more granular, and if you could explain to our listeners more about the mathematical calculation involved in measuring the 50% test.

[00:13:12] Charlie Rhuda, CPA: Sure. So the 50% test is a fraction, right? And again, simply stated the numerator of the fraction is your tax-exempt, private-activity bonds, and the denominator is your aggregate basis. And so in looking at both of those components, the numerator is fairly easy to it's fairly easy to understand because you will have gotten an allocation or you'll be getting an allocation of tax-exempt bond volume cap. So that's going to be in your numerator.

The two adjustments to the numerator is if the bond proceeds are earning interest prior to being dispersed, you can add that interest to your to the numerator, and then, I've only ever seen this once, but any discount or premium on the issuance of the bonds would also adjust the adjust the price. In all the years I've been doing this, I've only ever seen that once in a housing transaction. Usually the bonds are issued at par.

So now that we have the numerator we need to move on to the denominator and the denominator again is this concept known as the aggregate basis. And so the aggregate basis is going to include land and any associated land acquisition costs, real property transfer tax, broker fees title, right, those kinds of things.

It's going to include the building if you're purchasing an existing building. And again, the same thing, you know, any costs associated with the building, zoning, broker fees, all that. And then it's going to include your depreciable costs and not just the cost included in an eligible basis. So it's going to include non-LHTC units like may reference before for mixed income transactions that have both affordable and market-rate units, and this is going to include commercial space and other amenities as well. And so in the depreciable cost side, you know, in this case, you'd be looking at rehabilitation costs, if you're doing an acquisition-rehabilitation for the new construction costs, if you're building round up new construction.

[00:15:14] Michael Novogradac, CPA: Great. Thank you for that, Charlie. And I will also note that given the competitiveness for bonds in a lot of states, there's all sorts of limitations in many cases when you're doing mixed-income transactions, have commercial space in the rest, and you can have condo structures and master lease structures and the rest, but we'll save that for 202, or you can reach out to Charlie or see us at the upcoming Novogradac conference to go into some of those areas in more detail.
50% Test Frequency

I wanted to now move on, Charlie, to the frequency as to when these tests are normally performed and what listeners should know about when the 50% test needs to be satisfied.

[00:15:52] Charlie Rhuda, CPA: Right. So I'll sort of start with the practical answer to that. And the practical answer to that is at least twice, right? So the first time that you're going to do this is, you know, during the structuring phase prior to construction closing, right?

And the reason you're going to do that then is because you want to make sure that you're going to be passing the 50% test prior to, you know, closing on your construction financing and closing with your tax credit equity investor. Oftentimes, this is the point where you'll also be discussing with the state how much in volume cap bonds that you're going to be looking for.

And so, you know, we mentioned already that some of the states are volume cap constricted. And since those states are trying to do as much housing as possible, they'll actually limit you and they'll say, okay, we're going to loan you, we're going to provide you with enough allocation so that the 50% test is satisfied at 55%.

And so they're going to back into a number. And what this allows them is this allows them to spread their volume capital a bit more widely, as opposed to providing, you know, taxes and bonds for a much larger percentage of the financing stack. So again, feasibility concerns come in there. So that's the first time you do it, and you want to make sure that you have a deal that works.

The second time that it's done, is at bond conversion using the actual numbers. This is usually at the same time that the cost certification is being done.

And so part of what, why this is important is because the state is going to use the number calculator on the 50% test to put on line four of Form 8609. Part one of Form 8609 is, is filled out by the state. It includes the maximum credit dollar allowable the maximum qualified basis and tax credit rate will beyond that, and included within that will be the actual calculation from the 50% test.

The 50% test may also need to be done more frequently. We're going to talk a little bit later about multi- or multi-building placed-in-service but I'll talk a little bit more here about whether or not you're concerned about passing the 50% test.

As I mentioned a few moments ago, you know, a lot of states will limit the amount of volume cap they give you to a number that would pass the 50% test. I'd say 55%. And if you start to have cost overruns or if you have scope changes, right, those additional costs are going to start increasing your denominator, which is going to start to reduce your fraction. And so, so there are plenty of times where, where other developers will ask us to help them monitor the 50% test during the construction phase.
Michael Novogradac, CPA: So, let’s talk about that in terms of potential pitfalls, because we know, as I mentioned in the intro, that if you finance more than 50% of your aggregate basis, then you’re generally entitled to claim tax credits on 100% aggregate qualified basis, which is your eligible basis times your low-income occupancy percentage.

If you fail the 50% test and you finance less than 50% of your aggregate basis, then you’re only eligible to claim tax credits on a portion of your qualified basis financed with private-activity bonds. So it’s not technically a cliff in the sense that you don’t go from, you know, all your credits to none, but you go from all your credits to less than half. So it certainly feels like a cliff. It’s certainly enough of a fall that it would kill most transactions.

Pitfalls to Passing the 50% Test

So, you mentioned cost overruns as one way in which you could potentially run into a problem where, you know, a certain amount of bonds issued, your costs are rising, your aggregate basis is rising, such that maybe you’re getting close to being below the 50%. What are some other pitfalls that you see with clients that can lead to concerns about passing the 50% test?

Charlie Rhuda, CPA: So, some of the challenges would be cost overruns, as you mentioned a moment ago, because that enlarges the denominator. And then one of the other pitfalls that I see is that the bond’s not being drawn down quickly enough, and so it’s the amount of bonds expended. Expended means drawn and actually spent not necessarily put in a reserve or we’re sort of obligated but not actually not actually expended.

And so we run into this a lot where we have multi-building multi-year placed-in-service or, where we see this is if somebody is rushing to finish their construction by the end of the year. We know there’s a lag in construction requisitions, so you may be rushing to finish construction at the end of December but your November, you’ve certainly, your December requisition hasn’t been prepared yet because you haven’t gotten to the end of the month, your November requisition might not be funded, and then potentially your October requisition might not be funded.

And so you’ll get to the end of the year, and you’ll have all of the costs that you expected to incur, but your numerator is going to be short because you haven't actually drawn and expended the expended the bonds. And that, and that’s one area that catches a lot of people by surprise because people think about the test in aggregate and they forget that you have to satisfy the test by the end of the first year of the credit period.

Michael Novogradac, CPA: So that’s a good point about satisfying the test has to be either during construction or by the end of the first year of the credit period based on various private letter rulings and as you noted there’s essentially two ways you fail the test. Either, I should say, you fail the test if initially you're not going to close the transaction, if you're not projected to pass the test. So
that’s a given, the given that you go in expecting to pass the test. So you expect to have enough bonds to be more than 50% of your aggregate basis.

And as you noted, you know, the two ways you fail the test is that numerator is too low and that you don't issue all the bonds, you know, quickly enough. Or you don't receive proceeds from the bonds quickly enough. Or the denominator, it ends up rising. The aggregate basis number is rising because of cost overruns or some combination of the two.

**Advance Planning for 50% Test**

So what are some of the strategies that you share with clients that are doing this advanced planning? They see that they’re going to have a problem with the test for either the bonds not being issued quickly enough for their project, or since they issued, I should say, funding quickly enough, or they’re running into cost overruns. What’s some of the planning that developers can do?

[00:22:32] **Charlie Rhuda, CPA:** Well, the first thing that you can do is you can go back to the agency and ask for more bonds, right? And so, depending upon whether you’re in a state that’s volume cap constrained or not, that may or may not be an option. Again, if you’re doing this test up front, right while you're still underwriting the transaction before it's closed, you know, the state is evaluating all the applications that come. And so if you find out that there’s been an increase in construction costs preconstruction, you may be able to go back to the state and ask for some more bonds.

And again, because they're looking at funding, not only your transaction, but all the others, they're trying to figure out a way to maximize their allocation. So you may be able to do that if you're already in construction and the first amount of bonds have already been issued and are being drawn down. If you’re in a state that volume cap constrained, it's going to be very, very difficult to be able to be able to get the state to allocate you more bonds because they may just not have them to allocate you.

The second, this is the easiest, but this is the most unpleasant way, is to reduce your developer fee. Right, and for all you developers listening, I’m sure nobody wants to hear that, right? But one of the quickest and easiest way, by reducing your developer fee, you reduce your overall depreciable cost, it depreciates, it decreases the denominator and can help bring the help bring the task back into alignment.

I will note, it's very common in a partnership agreement to see the limited partner put in a provision that if it looks like the 50% test is not going to be passed, that the developer, which is usually related to the general partner will have to reduce the, may have to reduce the developer fee in order to satisfy the 50% test.

So one other, one other item to think about while you're negotiating the partnership agreement and negotiating the transaction with your tax credit investor. Other ideas are to review the capitalization of carrying costs. We know that qualified basis, eligible basis, qualified basis is what gets us our tax
credits. And so we're always looking to maximize the amount of costs that we can capitalize to help maximize our credit amount. So maybe not being quite as aggressive on capitalization.

And then the last one I would say taking some costs out of your project, right? And what does that really mean? One of the things that could mean would be to do a land lease where the land isn't actually transferred into your project that may be feasible condoing out certain costs, like if you've got a ground-floor commercial, you may put that in a separate condominium and then you'll no longer need to count that into your aggregate basis.

Or then we'll also see sometimes this is especially true if you've got a related-party general contractor, where they'll actually reduce some of the contract costs to help bring the denominator down and help the test to pass.

[00:25:40] **Michael Novogradac, CPA:** Great. Thank you for those solutions. And it's obviously, something gets customized for every transaction. Probably the only thing that I would add that I know we've had discussions about this between ourselves, Charlie, in the past when we were trying to work with a client that, you know, you first want to move out the nondepreciable costs that are part of aggregate basis. And I say that because if you pull out depreciable costs that are building up eligible basis, then when you pull those costs out, you'll have lower, fewer tax credits. So as a consequence of satisfying the 50% test, you end up potentially reducing your qualified basis, which means you have slightly less tax credit equity.

So you want to first pull out the nondepreciable costs, or the costs that are, won't affect your eligible basis, so that you can claim the maximum amount of tax credits. I don't know if you have anything more you want to comment on that, other than just saying. Yes, that makes sense.

[00:26:43] **Charlie Rhuda, CPA:** Well, so the land, land's non depreciable. It's not getting your tax credits. Your commercial space is nondepreciable. It's not getting your tax credits and your market rate units are depreciable. They're not getting your tax credits. So to the extent that you can remove them from the affordable entity it will help it will help improve the test for you.

[00:27:05] **Michael Novogradac, CPA:** Right, a lower aggregate base does not affect the amount of tax credit you're eligible for. And obviously, when you were initially doing the calculations at closing, you didn't have the cost overruns. Now you have the cost overruns, there's certainly on the one hand the credits you weren't initially counting on, but now that you have cost overruns, you would like the equity, but you would like to, you know, get additional credits and there could be issues with the state agency allowing you to put them on their cost caps and all the rest, but once again, that's a 202 or 302 topic and not for us to discuss more here.

**95%/5% Test Overview**

So now, if it's okay with you, I'd like to swing to the 95%/5% test.
Charlie Rhuda, CPA: Yeah, I think that's great.

Michael Novogradac, CPA: So we've covered the four areas that I mentioned in the intro with the 50% test. So now let's talk about the 95%/5% test. So if you could give an overview to our listeners, Charlie, as to what the 95%/5% test is.

Charlie Rhuda, CPA: So the 95%/5% test basically says that 95% of the proceeds of the issuance must be expended for qualified costs, right? So we're introducing another new term, qualified costs. The importance of the 95%/5% test is it determines whether the interest being earned on the bonds is tax-exempt in the hands of the purchasers of the bonds. Right? So we talked about the bonds in our 50% test discussion, but there's actually an investor who's buying those bonds, whether that's a bank or mutual fund or others, and they're expecting that the interest on those bonds to be exempt from federal income tax for their purposes.

In order to be able to certify that for the states they have to be able to show that most of the bond proceeds, 95%, are being used, again, for qualified costs. We're going to talk in a little bit about what the qualified costs are.

If you fail the 95%/5% test, then the bonds are not tax exempt. The interest is not tax exempt in the hands of purchasers, and if they're not taxes and bonds, then we don't get as-of-right tax credits to go along with it. So this one is actually a cliff test because you'll have no credits if you fail the test. Just a little sneak preview. The 95%/5% test usually is passed fairly easily because of tax credit equity that can pay for a lot of unqualified costs. But we'll talk about that again in a little bit.

Michael Novogradac, CPA: Great. Thank you for that, Charlie. And let me, for the benefit of at least some listeners, state what's probably obvious is it's called the 95%/5% test because 95% of the bond proceeds need to be used for good costs or qualified costs. And up to 5% can be used for nonqualified costs. So it's the 95%/5% test. So, with that, if you could share what's behind the mathematical calculations when the 95%/5% test is applied.

Charlie Rhuda, CPA: Yep, I actually did neglect one thing. So the 95%/5% test gets performed for all bond transactions, not just the ones generating low-income housing tax credits because we do see instances where tax-exempt bonds are used without low-income housing tax credits.

In those instances, if you don't have other sources or tax credit equity, it becomes very, very important to make sure that that 5% is sufficient to cover all the costs that would be unqualified. And again, we're going to talk about qualified and unqualified costs in a moment.

So, for the 95%/5% test, we're usually preparing the 95%/5% and the 50% test at the same time, right? It's the same set of numbers and it's pretty much the same timing that both of these tests need to be done, and we'll talk a little bit more about that.
So, some modifications. Qualified costs are those costs that are being capitalized to a building, right? That seems fairly simple and straightforward. Unqualified costs are those costs that cannot be capitalized to the building. Examples of which would be costs that would be amortized, like debt issuance costs, tax credit allocation fees, costs that would be expensed, or any other costs that would otherwise be treated as nondepreciable, right?

But there's some important modifications that we have to think about with the 95%/5% test. Again, sort of thinking about, you know, what we were talking about, the 50% test. One of those is related-party fees. Related-party fees are not considered to be qualified costs for these purposes. So even though they're depreciable, even though they're included in your tax credit basis, these costs are excluded from the qualified cost column and are considered to be unqualified costs that are paid with related-party debt, like a seller's note. Those costs are not available to be reimbursed in the bond proceeds. So those costs move into the unqualified column. And we see that a lot with acquisition-rehab, whether there's some relation between the old entity and the new entity that is selling the buyer as it's being done resyndication.

Then there's costs, what I'll call sticky financing. So, for example, if you get an energy efficiency loan that can only be spent on the windows, the cost of those windows are not available to be financed with the tax and bond costs. So in that case, again, you have windows, which are a good cost, capitalized eligible basis that might be considered to be unqualified solely because they have a a sticky financing source capitalized financing costs.

Certain construction finance fees and other indirect costs of construction are capitalized during the construction period. Those are generally going to be considered to be unqualified.

And last nonresidential costs. And this is always an interesting one. Community service facility, right, is something that is allowed to be included in an eligible basis subject to certain limitations. You need to be in a qualified census tract and there's some cost limitations. And so that's depreciable. It's includable on the eligible basis, but it's not considered to be a residential real property cost for purposes of the 95% test. So that would need to be excluded as well. So some important differences that that we wouldn't normally think about.

[00:33:25] Michael Novogradac, CPA: Is it too simple to say that when you think about the 95%/5% test and the 50% test, that if a state were to initially give you funding for, say, 50-55%, to give enough bonds to fund 55% of your aggregate basis, then when I apply the 95%/5% test, I’m basically saying that 95% of that 55% needs to be used for qualified costs?

[00:33:54] Charlie Rhuda, CPA: I think you could say that. I generally look at it a little differently. I say to myself, okay, here’s all my development costs, right? And here’s, and I'll start with my good costs, which are easy, which are the hard costs of construction and architecture, a number of those. And oftentimes, because you’ve got tax credit equity, and because, and especially in certain high-cost states,
you'll also have soft loan subsidies that the pool of sources that you have that could be assigned to the unqualified costs is great, and so oftentimes we see the 95%/5% test being passed with construction part cost and architect and a few other, other direct soft costs associated with it. So you can look at it, you can look at it in both ways.

[00:34:44] **Michael Novogradac, CPA:** In short, when you're getting 55% of aggregate basis covered by profitability bonds and the balance is tax credit equity and other sources, then in essence, you have a lot of good qualified costs. And to your point, when you don't have tax credit equity, because you're doing this financing without tax credits, then you can potentially have fewer other sources and fewer total costs, you know, the calculation can be a little bit trickier.

[00:35:15] **Charlie Rhuda, CPA:** That's right. That's right.

**95%/5% Test Frequency**

[00:35:17] **Michael Novogradac, CPA:** So now let's talk about the second of my sort of four categories, and that was how the frequency in which the tests are normally performed. What should listeners know about how often the 95%/5% test is performed?

[00:35:31] **Charlie Rhuda, CPA:** So, again, much like the 50% test, the test is performed twice. It's performed in the beginning to make sure that you can pass and that you have a deal. And then it's performed again at bond conversion using the actual numbers. And so we see this a lot with agencies. So as they're moving out of their construction phase into their permanent phase, and the way they would say it is closing out the bonds the 95 5 test will get done again at that point.

We do see in some limited circumstances where, where sometimes there's multiple bond issuances going into a transaction, or there may be a mandatory redemption and that, and so if there's been cost overruns, or we definitely saw this during COVID where there were construction delays, we had mandatory bond redemptions occurring prior to 100% completion of the project, and so the 95%/5% test needed to be done sort of on an interim basis for those for those mandatory redemptions.

I feel like that's a, you know, a hyper technical and an area that doesn't occur very often, but again, something to just keep in mind when, when thinking about when these, when these need, when these tests need to be done.

**Pitfalls and Planning for 95%/5% Test**

[00:36:44] **Michael Novogradac, CPA:** So we talked about some of the situations where the 50% test can become challenging to satisfy. What are some of the potential hurdles or pitfalls with 95%/5% test?
[00:36:57] **Charlie Rhuda, CPA:** Well, again, the good news, as I said, is that you've got a lot of other sources so, you know, to pay for the unqualified costs, and so that leaves the that leaves the bonds available for the for the better, the easier costs, the construction, architect, and such.

The few transactions where I’ve seen the 95% tests be challenging is we’ve got a high acquisition in relation to rehabilitation. So you’ve got a seller's note that's covering a large part of the a lot of the land in the initial building. You've got some sticky financing, right? That's maybe, that maybe can only cover certain kinds of costs. And then you've got additional related parties. You know, every now and then we see like the architect is related to the to the construction contractor who's related to the general partner. So in those cases, you could wind up taking a lot of your, again, good eligible basis, tax credit eligible costs, and moving them over into that unqualified column. And it starts to make it a little bit more difficult to have enough good costs left over to satisfy the test. But again, that happens very infrequently.

[00:38:10] **Michael Novogradac, CPA:** And then if they are facing some of those situations, I think I know the answer. Listeners probably can guess the answer, but what are some of the steps they can take to avoid failing the 95%/5% test?

[00:38:24] **Charlie Rhuda, CPA:** So, you know, reviewing the related party affiliations is certainly one way. Reviewing the restrictions on other sources. You know, if you've got a source that, again, can only pay for energy efficient windows and 95%, you may have to turn that source down in favor of another source. And then, again, just reviewing the capitalization policies about what costs, you know, can be capitalized and depreciable and what costs what costs cannot be.

**Additional Considerations and Wrap Up**

[00:38:55] **Michael Novogradac, CPA:** So, thank you for that, Charlie. So, we've covered a lot of ground. We've got a 50% test, a 95%/5% test. But I know there's a lot more that we could be covering, and there's even areas we've obviously already talked about now where we said we don't have time to go into those. But I will give you a chance to, you know, discuss a few other items that you think are worthy that developers, investors, and the like should be thinking about regarding these two tests.

[00:39:22] **Charlie Rhuda, CPA:** And these are all definitely 202 and 302 concepts, but I thought that I would introduce them to everybody. Multi-year, multi-building placed-in-service is always, is always challenging because since the 50% test needs to be passed at the end of the first year of the tax credit period if you have multi-year, multi-building going in over two or three tax years you're going to have to make sure that you've got enough tax-exempt bonds issued by the end, by the completion of your first phase, that you're going to be able to pass that 50% test, considering that you've got future phases coming up.
And so one of the suggestions I make to my clients is to make sure that they're either drawing the taxes and bonds readily with all the other sources, or drawing them early. I've had people tell me that, oh, my bond financing is expensive, and I've got these great subsidy notes at, you know, 1% or, you know, a lower interest rate. And so I'm going to draw those first to save on my interest costs. And then you get to the end of the first year of the credit period for your first phase, and you have enough bonds drawn to pass the 50% test. In that case, you're very likely to deferring the start of your credit period by another year which has negative consequences in the term of tax credit adjusters. So that's one.

The second one is master development with multiple condominiums and or master leases. I listen to my friends who are real estate attorneys. In some states and areas, it's easier to have condos or more difficult and in some places it's easier and more difficult to use master leases. I think the important concept for both of those is that they transfer ownership for tax purposes. Right, so regardless of whether it's a condominium or master base, and there's probably a lot of, you know, very important technical differences between the two of them that we won't reference here.

But in those cases, right, again, you need to be careful that your bond proceeds are being used to reimburse costs that are associated with the affordable piece of that, and that it's not being used to finance costs for other areas that are not included in the affordable portion of your transaction.

And then the last one, and I think this might be limited to just a few states, would have these mixed pool of bond sources. We've got tax exempt, recycled bonds and taxable issuances all being sort of pulled and requisitioned together. In this case specifically, you're going to want to make sure that the bond documents—it's sometimes, it's called the tax regulatory agreement.

It has other names for the document is clear that the intent is for the volume cap bonds to be financing. The affordable, whether it's an affordable condominium or affordable sub lessee, and that it's also clear about what the recycled bonds and what the taxable issuances can and should be funding.

So again, you know, this is more likely to be seen where you've got you know, multiple condominiums, affordable and market rate and or commercial. And so, again, you know, I'm just, I'm introducing the topic here, but there's a lot, there's a lot here to this one.

[00:42:41] Michael Novogradac, CPA: No, there definitely is. And I was thinking about the importance of the timing of the inducement resolution for the bonds. But I feel like we're going into too many, too much detail in too many other areas. We've already been going here for a bit. So I'll save that for your upcoming webinar.

I want to just maybe say thank you, Charlie for joining me on the podcast. And for listeners who want to contact you, I'll include your email in today's show notes.
And I would encourage listeners to reach out to Charlie, you know, we covered a lot in the podcast today, and it's a very arcane topic with lots of traps for the unwary and I also like to remind listeners, as I mentioned earlier, Novograds does have a number of other resources to learn more about the 50% test and the 95%/5% test, as well as the foreclosing more generally. I noted earlier that we have an upcoming webinar that Charlie will be co-leading on Aug. 17. It's entitled "Productivity Bonds and 4% Tax Credits Overview Webinar," and we also have the Low-Income Housing Tax Credit Working Group. And I'll include a link to that in our show notes.

But also if you just Google "Novograds Low-Income Housing Tax Credit Working Group," it’ll take you there. And I’d also remind listeners that we do have our conference coming up next month, our September Low Income Housing Tax Credit Bond Conference, Sept. 28-29 in New Orleans.

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And with that, I'll say, thank you again, Charlie, please stick around for our Off-Mike Section, where I get to ask you for some fun off topic recommendations from you and words of wisdom.

And to our listeners. I encourage you to tune in to next week’s episode. We’ll discuss three clean energy subsidies that are available to those working in affordable housing and using low-income housing tax credits. These three subsidies are the Homes Energy Rebate Program, that's a cash rebate program, the Section 45L Energy Efficient Home Tax Credit, as well as the solar investment tax credit. And I will focus next week on these in connection with low-income housing tax credit financed transactions, but they don’t require there be low-income housing tax credit financing. It could be affordable housing or market-rate housing more generally, depending upon the particular program. So, it is something that you want to listen to in any event.

And for the last of these three subsidies, the solar investment tax credit, the IRS did recently publish final regulations for the environmental justice adder tax credit percentages for clean energy facilities that are built in connection with federally subsidized residential buildings. And the IRS and the U.S. Department of Treasure also released a revenue procedure describing how to apply for an allocation of these credits. So I would encourage you to reach out to Novogradac office to help provide assistance in applying for these credits.

My guest next week to discuss these subsidies will be Brent Parker, he’s a partner in Novogradac's Long Beach, California office, and he's a regular guest on the show. Brent’s expertise spans several of the incentives Novogradac works with, including renewable energy, affordable housing, and opportunity zones. And if you have any questions you think we should cpas@novoco.com.
Off-Mike Section

So now we’re going to turn to our Off Mike Section, where I get to ask guests off topic questions to get their insight for our listeners. Now I mentioned in the intro, Charlie, that you’ve been at this CPA profession for more than three decades. What’s your best tip for adjusting to changes in our profession?

[00:46:33] Charlie Rhuda, CPA: Keep learning and be flexible. You know, I will say three decades means that I started before there were personal computers at everybody’s desk and we did a lot of things by hand. So I’ve seen a lot of changes and I know I’m going to see a lot more changes. And so you know, like I said, flexibility.

I try to think about the similarities and differences between what I’ve seen in the past and what I’m seeing in the future and try to keep, you know, keep keep the concepts fresh and look at the tools maybe as a little bit different to achieve the same goals and just you know, think about all your experiences.

I like to say this to my staff all the time. I learn something new every day. And that’s part of what I love about my job and I love about what’s challenging about, about the work that we do.

[00:47:25] Michael Novogradac, CPA: So conference season is just around the corner. You know, we don’t have conferences in August, people on vacation, like I am here in Japan, but it’s just around the corner.

And I mentioned that we have our conference on affordable housing in New Orleans coming up in the fourth week of September into the beginning of the end of the third beginning of the fourth week of September. And we also have our Renewable Energy Conferences coming up, New Market Tax Credits Conferences, Renewable Energy Tax Credits, Opportunity Zones Forum.

With all of that coming, what’s a travel tip that you’d recommend to our listeners?

[00:48:03] Charlie Rhuda, CPA: Well, my number one travel tip, and this may be fortunate for me because I live in a major city, is I only fly direct if I can.

[00:48:12] Michael Novogradac, CPA: That is a good tip.

[00:48:15] Charlie Rhuda, CPA: Weather doesn’t even have to be in the path of your flight in order to disrupt everything.

Summer travel, all of those things. You know, that’s not always an option. I always make sure that I’ve got all my electronics charged up. I do bring a Nook with me so if my if my laptop runs out of juice and I’m not on one of the newer planes that has a power bank or has a power supply to charge up my laptop I at least have a Nook that I can read.
This is also helpful when you have flights where the WiFi isn’t working again, right? It’s kind of nice. You got some in-flight entertainment and some other things, but you get on the plane and like, oh, my battery’s dead. Oh, the WiFi is dead. Oh, I have all of these problems that I’ve had before. So. I’ll keep my Nook and I’ll just read and relax a little bit.

[00:49:12] Michael Novogradac, CPA: Those are certainly first-world problems, as they say.

[00:49:16] Charlie Rhuda, CPA: They are, they are.

[00:49:17] Michael Novogradac, CPA: Yeah, kind of not so long ago my tip was to bring a splitter for that when you’re in the airport looking for power.

And if you didn’t have a splitter, then when all the power adapters were being used by other travelers, I could always go in and say, do you mind if I use this little splitter here and we can both use the same plug?

[00:49:42] Charlie Rhuda, CPA: My wife is the queen of that on family vacations. She brings a whole power strip. And if you go over to any one of those trees and ask somebody if she can plug in the power strip so they can plug in her thing, they always say yes. And then they say, Oh, and I’ve got something else to charge too. That’s a great one.

[00:49:59] Michael Novogradac, CPA: Good way to make friends.

[00:50:01] Charlie Rhuda, CPA: Yes. Yes.

[00:50:02] Michael Novogradac, CPA: So thank you, Charlie. And to our listeners, I’m Mike Novogradac. Thanks for listening.
Additional Resources

**Emails**
Charlie Rhuda

**Webinar**
Novogradac Private Activity Bond and 4% LIHTC Overview Webinar

**Conference**
Novogradac 2023 Housing Tax Credit and Bonds Conference

**Working Group**
LIHTC Working Group

**Tax Credit Tuesday podcasts**
May 10, 2022: Comparing 4% LIHTCs and 9% LIHTCs

**Previous ‘So You Want to Be a LIHTC Developer’ Podcasts**
June 27, 2023: So You Want to Be a LIHTC Developer: The Critical Placed-In-Service Application

June 13, 2023: So You Want to Be a LIHTC Developer: Tax Considerations When Partnering with Nonprofit Developers

Jan. 17, 2023: What LIHTC Developers Should Know About Form 8609

Dec. 6, 2022: So You Want to Be a LIHTC Developer: 5 Keys to Successfully Meeting LIHTC Tax, Audit and Investor Deadlines

Nov. 29, 2022: So You Want to Be a LIHTC Developer: Operating Expenses and Income

Nov. 22, 2022: So You Want to Be a LIHTC Developer: Final Cost Certifications

Nov. 1, 2022: So You Want to Be a LIHTC Developer: Location and Market Considerations