

50% Test Timing for Multiple-Building Projects—Avoiding Traps for the Unwary*

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Tax-exempt bond transactions involving low-income housing tax credits (LIHTCs or Credits) are complex financial structures, given the interaction of (1) the tax-exempt interest rules under Code Section 103 of the Internal Revenue Code of 1986, as amended (Code), (2) the volume cap rules of Code Section 146, and (3) the LIHTC rules under Section 42 of the Code. The interpretation of the LIHTC rules is not always clear, given the guidance provided by the Internal Revenue Service (IRS) to date. This article discusses the interaction of the so-called “50% Test” described in Code Section 42(h)(4) (B) with different tax-exempt bond structures and LIHTC projects consisting of multiple buildings which may be placed in service in different tax years.¹

*[DISCLAIMER: The foregoing discussion is general in nature and is not a tax opinion or advice of this firm. Further factual development and legal analysis would be required before any tax advice could be given. As such, the foregoing is not intended to be used, and may not be used by any direct or indirect recipient, for the purpose of (i) avoiding any penalties that may be imposed on such recipient, or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.]

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I. Overview of Qualification for LIHTCs with Tax-Exempt Bond Financing

A LIHTC project that is expected to be financed with tax-exempt bonds under Internal Revenue Code Section 146 will not receive an allocation of Credits from the state housing credit agency's (Credit Agency) annual allotment, for which projects participate in a competitive application process.² Typically, such an allocation is required as a prerequisite to the use of the Credit in connection with a qualifying low-income housing project.³ Instead, a LIHTC tax-exempt bond project will rely on Code Section 42(h)(4) in order to avoid the need for an allocation. Section 42(h)(4) provides the following:

(4) Credit for buildings financed by tax-exempt bonds subject to volume cap not taken into account

(A) In general

Paragraph (1) shall not apply to the portion of any credit allowable under subsection (a) which is attributable to eligible basis financed by any obligation the interest on which is exempt from tax under section 103 if—

- (i) such obligation is taken into account under section 146, and
- (ii) principal payments on such financing are applied within a reasonable period to redeem obligations the proceeds of which were used to provide such financing or such financing is refunded as described in section 146(i)(6).

(B) Special rule where 50 percent or more of building is financed with tax-exempt bonds subject to volume cap

For purposes of subparagraph (A), if 50 percent or more of the aggregate basis of any building and the land on which the building is located is financed by any obligation described in subparagraph (A), paragraph (1) shall not apply to any portion of the credit allowable under subsection (a) with respect to such building.⁴

The default rule under Section 42(h)(4)(A) is that one gets Credits based on the percentage of eligible basis financed by tax-exempt bonds. Thus, a project that has forty percent of its eligible basis financed with tax-exempt bonds would get Credits on forty percent of the eligible basis. However,

1. Transactions structure with tax-exempt notes may also qualify for Credits, and references in this article to tax-exempt bonds may also include tax-exempt notes.

2. I.R.C. Section 42(h)(4) states that qualifying projects are exempt from the limitations of Section 42(h)(1)(A). All references to sections in this Article refer to sections in the Internal Revenue Code, which is title 26 of the U.S. Code.

3. See IRC § 42(h)(1)(A) (a building is limited to the number of Credits allocated to it under Section 42(h)(1)).

4. IRC § 42(h)(4).

that general rule is swallowed by the exception in 42(h)(4)(B), which provides that one can get Credits on *all* of the eligible basis if fifty percent or more of the aggregate basis of any building and the land on which the building is located is financed with the tax-exempt bonds (50% Test).

For a tax-exempt bond project to get any Credits under Section 42(h)(4), rather than by having the Credit Agency allocate Credits, certain requirements have to be met. First, interest on the bonds must be exempt from tax under Code Section 103. Second, the bonds must be taken into account under the volume cap rules of Code Section 146.⁵ Third, principal payments on the financing have to be applied within a reasonable period to redeem the tax-exempt financing⁶ or such financing is refunded as described in Code Section 146(i)(6).

To qualify for Credits by use of tax-exempt bonds, the project must also receive the following: (i) a certification from the Credit Agency pursuant to Code Section 42(m)(1)(D) stating that the project satisfies the requirements contained in the Credit Agency's qualified allocation plan; and (ii) a certification from the bond issuer under Code Section 42(m)(2)(D) indicating that the project's anticipated Credit amount does not exceed the amount of Credit necessary for the project's financial viability.

Note that the 50% Test is based on the aggregate basis of the building and the land upon which it is located.⁷ At a minimum this amount will exceed eligible basis because eligible basis includes only the cost of the building and does not include land.⁸ The building portion of aggregate basis might also exceed the Section 42 eligible basis because aggregate basis includes the full depreciable cost of the building. Such depreciable cost might be more than eligible basis because the latter excludes items that are not capitalized into residential rental property (e.g., commercial space costs, permanent financing fees).⁹ Consider the below example:

Example 1

Assume that a partnership borrows \$12,400,000 of construction financing funded with the proceeds of an issuance of tax-exempt bonds subject to volume cap under Section 146 of the Code. The partnership buys an

5. *Id.* § 42(h)(4)(A)(i).

6. *Id.* § 42(h)(4)(A)(ii).

7. Aggregate basis also includes "all property, including Section 1245 property and depreciable land improvements financed with the proceeds of tax-exempt bonds." Private Letter Ruling (PLR) 200035016. Note that a private letter ruling or other written determination from the IRS may not be used as precedent by any taxpayer other than the taxpayer to whom it is addressed. However, such rulings and determinations may reflect the IRS's then current position with respect to an issue.

8. See IRC § 42(d); see also PLR 200035016 (aggregate basis of a building includes all property including Section 1245 property and depreciable land improvements). Note also that the land cost included in the calculation may include costs capitalized to the land in addition to the purchase price of the land (e.g., demolition costs).

9. IRC § 42(d)(4)(A).

apartment building and land from a related party seller for \$3,000,000 (\$500,000 of which is attributable to land). The building includes first floor commercial space representing five percent of the fair market value of the acquired building and five percent of the space in the building. The costs of the project are listed below:

Table 1- Basis Calculations

	Project Cost	Aggregate Basis	Eligible Basis
Related Party Land Acquisition ¹⁰	\$500,000	\$500,000	\$0
Residential Rental Space Acquisition	2,375,000	2,375,000	2,375,000
Commercial Space Acquisition	125,000	125,000	0
Residential Rental Rehabilitation Hard Costs (e.g., construction contract, personal property)	14,250,000	14,250,000	14,250,000
Commercial Space Rehabilitation	750,000	750,000	0
Residential Rental Soft Costs (e.g., architect, engineering)	2,375,000	2,375,000	2,375,000
Commercial Space Soft Costs	125,000	125,000	0
Developer Fee (allocable to residential rental)	1,900,000	1,900,000	1,900,000
Developer Fee (allocable to commercial space)	100,000	100,000	0
Construction Bond Issuance Costs (capitalized into building as an indirect cost of construction)	200,000	200,000	0
Construction Interest and Non-Issuance Construction Loan Fees (allocable to residential rental)	1,235,000	1,235,000	1,235,000
Construction Interest and Non-Issuance Construction Loan Fees (allocable to commercial space)	65,000	65,000	0

10. Note land purchased from a related party should be included in aggregate basis for purposes of the 50% Test, but would not be considered a Good Cost for the 95-5 Test (defined below).

	Project Cost	Aggregate Basis	Eligible Basis
Taxable Permanent Loan Fees	250,000	0	0
Non-Depreciable or Expensed! Amortized Non-Land Costs (e.g., syndication fees, reserves)	250,000	0	0
Total	\$24,500,000	\$24,000,000	\$22,135,000

Tax-Exempt Construction Bonds Subject
to Section 146 Volume Cap

\$12,400,000

Aggregate Basis

\$24,000,000

50% Test

51.67%

The bond documents also provide that all \$12,400,000 of bond proceeds will be allocated to residential rental hard costs. The construction bond loan is repaid after placement in service of the building.

Analysis: Total Development Costs are \$24,500,000, but only \$24,000,000 is included in aggregate basis because permanent financing costs and expensed or amortized costs are not capitalized into the land or building and therefore are excluded. As a result, the 50% Test is satisfied at 51.67%, as illustrated above. It is notable that eligible basis is \$22,135,000, which is \$1,865,000 lower than aggregate basis because the commercial costs are also included in aggregate basis but excluded from eligible basis.¹¹

If the construction bond loan had only been \$11,500,000, then the building would have failed the 50% Test because only 47.92%¹² of the aggregate basis of the building and the land under the building was financed by bond proceeds. In such a case, only 47.92% of the project's basis-eligible costs would qualify for the Credit.¹³

II. 50% Test Complexities

At first glance, the 50% Test might not seem complicated. The denominator is the basis of the land and building. The numerator is the amount of bonds financing the land and building. One might hope this is a simple division of numerator by denominator and see if you are at 50% or more. But when one starts to compute the 50% Test, a number of issues may occur.

11. Treas. Reg. § 1.42-6(b)(1); 2 H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-90 (1986), 1986-3 (Vol. 4) C.B. 90.

12. \$11,500,000 bond proceeds ! \$24,000,000 aggregate basis = 47.92.

13. IRC § 42(h)(4)(A). Note that Regulation 1.42-1T(f)(1)(iii) suggests that a project under the fifty percent threshold could receive an allocation of credit from the Credit Agency to get credits on the remaining basis. Technically this may be allowable, albeit at the lower four percent credit rate rather than the higher nine percent rate that generally applies to buildings receiving allocations of credits from credit agencies. However, the authors have never seen such a situation as the industry practice is to ensure that the 50% Test is met.

*A. When Do Amounts Have to Be Expended to Be Included
in the Numerator of the 50% Test?*

Section 42(h)(4)(B)'s requirement that 50% or more of the aggregate basis of a building and the land on which it is located does not specify when the 50% Test must be met. Some IRS rulings concluded that the 50% Test could be met at placement in service, while other rulings stated it could be met at the end of the first year of the ten-year Section 42 credit period.¹⁴¹⁵ For a number of years it was unclear to practitioners if the 50% test was met only at one of these two points or whether it could be met anytime in-between. Subsequently, the IRS issued Private Letter Ruling (PLR) 201049018, which answered this question. The private letter ruling concluded that the redemption of all or any portion of the bonds used to satisfy the 50% Test *after* the project has been placed in service and after the 50% Test has been met, but *before* the end of the first year of the credit period for the building, will *not* in and of itself result in a determination that the building was *not* financed with tax-exempt bonds under Code Section 42(h)(4)(B).

B. How Are Bond Proceeds Allocated to Project Costs?

Often the loan disbursement procedure contemplated for bond proceeds does not necessarily ensure that 50% or more of the aggregate basis of each project building and land will be funded with the proceeds of the project's tax-exempt bond financing. For example, bond proceeds might be 50% of the basis of the land and building, but not 50% or more of land and building and "bad costs," such as bond issuance costs, permanent loan origination fees, and reserves. Or there might be multiple buildings and there could be questions as to how bond proceeds are allocated between the buildings.

Fortunately, Treasury Regulation Section 1.42-1T(f)(1)(ii) provides the following helpful rules with respect to the allocation of bond proceeds in a Credit project:

For purposes of determining the portion of proceeds of an issue of tax-exempt bonds used to finance (A) the eligible basis of a qualified low-income building, and (B) the aggregate basis of the building and the land on which the building is located, the proceeds of the issue must be allocated in the bond indenture or a related document (as defined in § 1.103-13(b)(8)) in a manner consistent with the method used to allocate the net proceeds of the issue for purposes of determining whether 95 percent or more of the net proceeds of the issue are to be used for the exempt purpose of the issue. If the issuer is not consistent in making this allocation throughout the bond indenture and

14. Section 42(f)(1) defines "Credit Period" to mean, with respect to any building, the period of ten taxable years beginning with the taxable year in which the building is placed in service or at the election of the taxpayer, the succeeding taxable year.

15. Special rules apply to the determination of the credit period for multiple building projects and the credit period may include the eleventh year of such period as provided in IRC § 42(f)(2).

related documents, or if neither the bond indenture nor a related document provides an allocation, the proceeds of the issue will be allocated on a pro rata basis to all of the property financed by the issue, based on the relative cost of the property.¹⁶

To avoid uncertainty as to whether project building(s) meet the 50% Test, it is important that the allocation of the bond proceeds be set forth in the bond documents.

The determination of whether 95% or more of the net proceeds of a bond issuance are used for the exempt purpose (referenced above) is often referred to as the "95-5 Test" or the "Good Cost/Bad Cost Test." For a bond issuance to be treated as tax-exempt under Code Section 142, 95% or more of the bond proceeds must be spent on "qualified facilities," which include qualified residential rental projects (referred to as "Good Costs").¹⁷ In connection with issuing an opinion that the bonds will be treated as tax-exempt for federal income tax purpose, bond counsel examines the project expenditures to which the bond proceeds are to be allocated. Examples of "Good Costs" include depreciable costs, such as hard costs and soft costs of construction of a qualified residential rental property, or the cost of the underlying land. Examples of "Bad Costs" include costs paid to acquire or rehabilitate non-residential rental property, bond issuance costs, related party acquisition costs, permanent loan origination fees, and reserves. An issuer may apply "any reasonable, consistently applied accounting method" to account for the proceeds of an issuance.¹⁸ To ensure that the 95-5 Test is satisfied, the bond documents often will expressly list the expenditures upon which the bond proceeds are to be spent. Up to 5% of bond proceeds can be used to pay Bad Costs while still satisfying the 95-5 Test, although only 2% can be allocated to bond issuance costs.¹⁹

16. Note that Treasury Regulation Section 1.42-1T(f)(1)(ii) was issued prior to the amendment of IRC § 42(h)(4)(B) to reduce the threshold percentage required to exempt a building from the limits of § 42(h)(1) from seventy percent to fifty percent. Revenue Reconciliation Act of 1989 Pub. L. No. 101-239, § 7108(j).

17. IRC § 142(a)(7). The tests to determine whether a LIHTC project qualifies as a qualified residential rental project for IRC § 142 purposes are similar to the tests under IRC § 42(g). See General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong.; Pub. L. 99-514, at 157 ("For purposes of the low-income housing credit, the term residential rental property generally has the same meaning as residential rental property within Code section 142(d)."). See also Rev. Rul. 98-47. However, there is no equivalent to the new average income set aside test described in IRC § 42(g)(1)(C) for IRC § 142 purposes. Also, under IRC § 142(d), the income restrictions must be met on the project as a whole, rather than on a building-by-building basis.

18. IRC § 148-6(a)(3).

19. IRC § 142(a) provides that the term "exempt facility bond" means any bond issued as part of an issue 95% or more of the net proceeds of which are to be used to provide any exempt facility described in IRC § 142(a). Section 147(g)(1) provides that a private activity bond shall not be a qualified bond if the issuance costs financed by the issue exceed 2% of

Notwithstanding the above flexibility for 5% and 2% of bond proceeds to be Bad Costs, in order to maximize the amount of the bond loan that is used to finance the Project for 50% purposes, it is advisable to have the bond documents provide that 100% of bond proceeds are to be allocated to Good Costs. This is because Section 42(h)(4)(A) only includes in the numerator of the 50% Test bond proceeds spent on the building and land. To the extent the bond proceeds are allocated to Bad Costs that do not finance the land or building,²⁰ that amount of the bond proceeds should be subtracted from the numerator of the 50% Test for Code Section 42 purposes.²¹ This can have the unhelpful impact of reducing the amount of bond proceeds used in the numerator of the 50% Test and possibly causing a building to fail the test.²²

Example 2 – Implications of Using Bond Proceeds to Pay Bad Costs

To see the impact of allocating bond proceed to Bad Costs, let’s use Example 1 from above. However, let’s assume that \$500,000 of bond proceeds are attributed to permanent loan fees. This results in the amount of bonds remaining to meet the 50% Test being reduced to \$11,900,000.

Tax-Exempt Construction Bonds Subject to Section 146 Volume Cap	\$12,400,000
Less Bonds Spent on Bad Costs	– \$500,000
Total	<u>\$11,900,000</u>
Aggregate Basis	<u>\$24,000,000</u>
50% Test	49.58%

the proceeds of the issue. See also Rev. Rul. 90-51 (payment of issuance costs for an issue of private activity bonds from proceeds of the issue is not a qualifying use of bond proceeds for purposes of IRC § 142(a)).

20. Not all Bad Costs must be excluded from the 50% Test. Technically, using bond proceeds to finance commercial space in a residential rental building would be a Bad Cost. However, because that commercial space is part of the building, it could be included in the numerator if the bond documents do not exclude commercial space as a use of bond proceeds. Commercial space in such a building would automatically be included in the denominator as part of the cost of the building and land.

21. See IRC § 42(h)(4)(B) (Credits are allowed on one hundred percent of eligible basis if fifty percent or more of the aggregate basis of any building and the land on which the building is located is financed by tax-exempt bonds subject to volume cap.).

22. Note that IRC § 42 Low Income Housing Credit Audit Tax Guide, pt. III, chap. 11, pp. 129–30 (Aug. 11, 2015), provides an example in which an examiner reviewed the tax-exempt bond indenture that specified that tax-exempt bond proceeds were to be used to finance certain Bad Costs, and as a result, the examiner determined that the project did not pass the 50% Test.

This only equates to approximately 4.03%²³ of the bond proceeds, so the allocation of bond proceeds would still satisfy the 95-5 Test and not cause the bonds to become taxable. However, the 50% Test calculation will only result in 49.58%²⁴ of the aggregate basis of the LIHTC project being financed with tax-exempt bonds. Given the interaction between the bond proceed allocation for Code Section 142 purposes and Code Section 42 purposes, it is important that LIHTC tax counsel work closely with bond counsel during the bond allocation process. It is often possible to allocate 100% of bond proceeds to Good Costs by allocating other funding sources to the payment of Bad Costs, so that the full amount of the bond issuance can be included in the numerator of the 50% Test.

C. How Does the 50% Test Work for Multiple Buildings?

Technically, Section 42(h)(4)(B) discusses meeting the 50% Test for a *building* and that a qualifying *building* gets credit on all of its eligible basis. Therefore, it appears that each building must establish that tax-exempt bonds have financed 50% or more of the building and its underlying land. Thus, the 50% Test applies on a building-by-building basis and not on a project basis. This raises the issue of how to analyze the 50% Test for a LIHTC tax-exempt bond project with multiple buildings.

1. Allocation of Bond Proceeds to Multiple Buildings

The bond indenture and other documents typically allocate proceeds to classes of assets, such as land, building, site improvements, and personal property for 95-5 Test purposes. However, the documents do not typically allocate bond proceeds among multiple assets of the same type. Thus, the bond documents themselves typically do not assure that 50% of each building is financed with tax-exempt bond proceeds. However, Regulation Section 1.42-1T(f)(1)(ii) should operate in such a circumstance to allocate the bond proceeds to a class of assets pro rata among the assets included in that class.²⁵ Thus, if bond proceeds are allocated to hard construction costs for three identical buildings, the bond amount allocated to hard costs should then go to all three buildings pro rata.

2. When Are Bond Proceeds Considered to Have Financed a Specific Building?

Regulation Section 1.42-1T(f)(1)(ii) does not address when bond proceeds need to be spent by the project. Such timing issues can become more complicated because of the different ways in which bonds can be structured. Traditionally, the full amount of a bond issuance was loaned to a borrower at the time of issuance. Funds not needed on the day of issuance would be

23. $\$500,000 \text{ Bad Costs} / \$12,400,000 \text{ Total Bonds} = 4.03\%$

24. $\$11,900,000 / \$24,000,000 = 49.58\%$.

25. PLR 9528002 (1995).

put into an escrow or other account and held until needed. In recent years, a “draw-down” structure has become much more common. In such a structure, tax-exempt bond proceeds are incrementally loaned to the borrower over a period of time as the funds are needed. The draw-down structure can minimize the amount of interest incurred by the borrower on the funds. The traditional fully funded bond offerings are commonly seen when credit agencies or governmental entities make a public offering of bonds. Alternatively, bonds issued as part of a private placement to institutions and sophisticated investors (rather than the public at large) often utilize the draw-down structure. The bond indenture and related documents will set out the procedure for the borrower to request bond proceeds be paid to the borrower (i.e., to subsequently pay construction costs). With a draw-down bond structure, typically payments of bond proceeds will be made on a monthly basis to allow the borrower to reimburse the general contractor for construction costs incurred for that month and to pay for other project costs.

Tax-exempt bond proceeds are not considered to have financed the aggregate basis of a building and the underlying land for 50% Test purposes until such proceeds are expended for land and building costs and such proceeds remain outstanding at the time the 50% Test is satisfied.²⁶ As a result, while a fully funded bond offering is loaned to the borrower on the day of issuance, that does not mean the bond proceeds have been expended for purposes of the 50% Test.

As discussed above, based on PLR 201049018, the 50% Test can be met anytime between the placement in service of a building and the end of the first year of a building’s credit period. This is a favorable conclusion and means that placement in service of a building does not need to be delayed until all bond proceeds have been expended in this case. However, this can create interesting issues when a tax-exempt bond issuance is used for a project with multiple buildings. To maximize yield and pricing, developers and investors want projects to deliver credits as soon as possible. Often one or more buildings in a project are completed and available for lease up in one tax year, and it is desirable to meet the 50% Test for those buildings in that year and have that year be the first year of the credit period for such buildings. However, other buildings may only be partially complete during that year and will not be available until a subsequent year. In such a situation, how can one determine if the 50% Test was satisfied for the early buildings during that first year?

Another issue could arise if insufficient bond proceeds have been drawn down and expended on project costs in the year that the first buildings are completed. This may mean that not enough tax-exempt bond proceeds were drawn and expended to satisfy the 50% Test with respect to the overall

26. See PLR 201049018 (Dec. 10, 2010).

project and thus it may not be satisfied for the early buildings. This situation could occur where the project simply has not incurred enough costs to spend sufficient tax-exempt bonds, or perhaps the project has lower interest loan proceeds or equity available that can be spent first, thus reducing the project's overall interest expense and providing a cost savings.

The below example helps illustrate the issues that can arise with multiple buildings and suggests some possible solutions.

Example 3 – Early Building Trying to Meet the 50% Test

Assume that a partnership has a four-building new construction project with \$21,000,000 of total development costs and financing as shown below.

Table 3.1

Uses	Budget	Eligible Basis	Bond Proceeds	Aggregate Basis
Land Acquisition	\$4,000,000	\$0	\$0	\$4,000,000
Construction Costs— \$4,000,000 per building	16,000,000	16,000,000	10,500,000	16,000,000
Non-Depreciable or Expensed Costs	1,000,000	0	0	0
Total	21,000,000	16,000,000	10,500,000	20,000,000
				x 50%
Bond Amount Needed for 50% Test				\$10,000,000

Sources

Tax-Exempt Construction Bond Loan	\$10,500,000
Permanent Loan	5,000,000
Construction/Permanent Subordinate Debt	10,100,000
Investor Equity	5,900,000
Total Permanent Sources	\$21,000,000

The Partnership buys land for \$4,000,000 in 2023 and will be constructing four identical buildings for \$4,000,000 each. The bond documents provide that all \$10,500,000 of the bond proceeds will be spent on the construction costs. The first building is expected to be completed and rented up in late 2024, and the other three buildings will be completed and rented up in early 2025. Table 3.2 below shows the status of the project as of the end of 2024.

Table 3.2
Expenditures as of End of Year 1 (2024)

	Building 1 Good Cost Expenditures	Building 1 Aggregate Basis	Building 2-4 Good Cost Expenditures	Total Good Cost Expenditures	Total Aggregate Basis Expenditure
Percent Complete	100%	0%	80%		
Related Party Land Acquisition*	0	1,000,000	0	0	4,000,000
Construction Costs - \$4,000,000 per building	4,000,000	4,000,000	9,600,000	13,600,000	13,600,000
Non-Depreciable or Expensed Costs	0	0	0	0	1,000,000
Total	4,000,000	5,000,000	9,600,000	13,600,000	18,600,000
		x 50.00%			
Bond Amount Needed for 50% Test		2,500,000			
	Bonds Expended in Year 1	8,000,000			
	Yr 1 Good Cost Expenditures	+13,600,000			
	Percentage	59%			
	Yr 1 Good Cost Expenditures	13,600,000			

	Related Party Land Acquisition*	+4,000,000			
	Total Aggregate Basis at end of Yr 1	17,600,000			
	Bonds Expended in Year 1	8,000,000			
	Total Aggregate Basis at end of Yr 1	--17,600,000			
	Project 50% Status at End of Yr 1	45%			
	Building 1 Yr 1 Good Costs	4,000,000			
	Building 1 % of All Good Costs Spent in Yr 1	x 58.82%			
	Building 1 Share of Bonds	2,352,941			
	Building 1 Aggregate Basis	--5,000,000			
	Building 1 50% Test	47.06%			
	Pass/Fail 50% Test	Fail			

As of the end of 2024, Building 1 is complete at a cost of \$4,000,000. Buildings 2–4 have a total cost of \$12,000,000 but are each eighty percent complete for a total of \$9,600,000. To minimize interest on the tax-exempt bond loan, the partnership only expended \$8,000,000 of bond proceeds as of the end of 2024. The balance of costs was funded by subordinate debt that carried a more favorable interest rate.

Analysis: To meet the 50% Test, the test must be satisfied for Building 1 in 2024, which is desired to be the end of the first year of its credit period. Private Letter Ruling 201049018 indicates that bond proceeds expended after a building’s placement in service, but before the end of the first year of the credit period (i.e., 2024) can count toward the 50% Test. Since the credit period for Building 1 starts in 2024, we can only utilize the bond proceeds spent prior to December 31, 2024, in the 50% Test. Thus, a sufficient amount of bond proceeds must be disbursed and expended on Building 1 prior to the end of Year 2024. How do we determine how much of the \$8,000,000 of bonds that have been expended as of the end of 2024 have been spent on Building 1?

Based on Regulation Section 1.42-1T(f)(1)(ii) and PLR 9528002, absent language in the bond documents stating otherwise, bond proceeds should be allocated on a *pro rata basis* to all of the “property” financed by the issue. Since all four buildings are financed by the issuance of the tax-exempt bonds, and the bond documents are silent on allocation in our example, the result is that the \$8,000,000 of expended bond proceeds should be allocated over the \$13,600,000 of construction costs pro rata. That would result in 58.82% of the \$4,000,000, i.e., \$2,352,941, of Building 1 construction costs being financed by tax-exempt bond proceeds. As illustrated below, this is only 47.06% of the total aggregate basis of the project that has been paid for during 2024 and thus the 50% Test would not be satisfied for Building 1 in 2024.

Tax-Exempt Bonds Expended on Building 1	\$2,352,941
Building 1 Aggregate Basis	\$5,000,000 ²⁷
50% Test	47.06%

How to Solve Building 1’s 50% Test Problem:

There are a number of ways to make sure that Building 1 does not fail its 50% test: deferring the start of the first year of the credit period for Building 1, spending more bond proceeds in 2024, or possibly working with bond counsel to disproportionately allocate 2024 bond proceeds to Building 1.

Solution 1—Defer Start of Credit Period. Section 42(f)(1) provides that the first year of a building’s credit period is the year that it is placed in

²⁷ Building 1’s aggregate basis is \$5,000,000: \$1,000,000 share of land costs plus its \$4,000,000 of construction costs.

service or at the election of the taxpayer, the succeeding year. If the partnership elected to defer the first year of the credit period to 2025, then all of the bonds would be expended by the end of that year, and all four buildings would satisfy the 50% Test in 2025. However, this is not always a desirable outcome because deferring the first year of the credit period would mean that the LIHTC investor would have to wait an additional year before receiving any credits. This might reduce the LIHTC investor's yield in a sufficient amount that it would reduce its investment in the project. Yet, if the number of credits that were to be delivered in 2024 was small, this may not meaningfully impact the investor's yield and what it would invest.

Solution 2—Spend Bonds Earlier. A second alternative could be to expend more bonds in 2024 and use less of the project's other financing so that the 50% test is met for all project costs incurred at the end of 2024. This is a common approach and is implemented by having the general partner represent that if buildings will be placed in service in multiple years, then by the end of the year when the first buildings are placed in service, bond proceeds will have been expended in an amount to exceed 50% of the aggregate basis of all buildings as of the end of that year. For example, if instead of spending only \$8,000,000 of bond proceeds by the end of 2024, the amount was increased to \$9,000,000. Bond proceeds of \$9,000,000 would exceed 50% of the project's \$17,600,000 aggregate basis at the end of 2024. And allocating a pro rata portion of the bonds to Building 1²⁸ results in \$2,647,059 of bonds being allocated to Building 1. As illustrated below, Building 1 ends up with a 50% Test of 52.94%.

Tax-Exempt Bonds Expended on Building 1	\$2,647,059
Building 1 Aggregate Basis	\$5,000,000 ²⁹
50% Test	52.94%

But it is worth noting that this approach can have a consequence. If the interest rate on the bond proceeds was higher than the interest rate on the other financing, this approach could result in higher costs for the project.

Solution 3—Change Allocation of Bond Proceeds The authors once arrived at a third alternative by working with bond counsel to allocate more bond proceeds to early buildings in a transaction. The approach was to specify in the bond documents that bond proceeds spent in a particular year are to be allocated to a particular building. Relative to Example 3, the bond documents could provide that something like \$2,650,000 of bond

28. With \$9,000,000 of expended bond proceeds, bonds would represent 66.18% of the construction costs (which does not include land, which is part of aggregate basis). Applying 66% to Building 1's \$4,000,000 of construction costs means that \$2,647,059 of construction costs would be financed with bond proceeds.

29. Building 1's aggregate basis is \$5,000,000: \$1,000,000 share of land costs plus its \$4,000,000 of construction costs.

proceeds expended in 2024 would be allocated to Building 1. Tying the bond proceeds to a particular building can ensure those bond proceeds are attributed to buildings that are expected to be placed in service earlier than other buildings. The bond documents should specify that bond proceeds drawn and expended in the early year will be allocated to project buildings placed in service in 2024 in an amount in excess of 50% of each project building placed in service in 2024. The authors do not recommend being too close to 51%. Often 53% or higher is required by investors or credit agencies. Such an allocation ensures that 50% or more of the aggregate basis of each building placed in service in an early year will be funded with the proceeds of the project's tax-exempt bond financing. Given the ever-changing nature of construction and in order to provide flexibility, the parties may consider adding to the bond documents a requirement that the allocation of bond proceeds to buildings placed in service in the first year be updated by the partnership by the end of such year to ensure satisfaction of the 50% Test.

3. Bond Loan Repayment Timing Problem

In determining if the 50% Test will be met, one must look not only at when bond proceeds are expended, but also at when the bond loan is *repaid*.³⁰ The critical fact is that one does not want to repay bond proceeds before the 50% Test has been completed for all project buildings. However, permanent financing interest rates are often lower than rates for construction financing due to the lower risk profile of the loan. As a result, there is an incentive to try and repay a bond loan with proceeds from the permanent financing earlier in order to lower the amount of interest incurred by a project. However, repaying the bond loan too early can create a 50% Test problem. The IRS has issued rulings that address when the 50% Test must be met as compared to the timing of the repayment³¹ of the underlying tax-exempt bonds. Based on these rulings, there appear to be three scenarios.

- Option 1: Repay the bond loan after placement in service *if* the 50% Test was met when the building was placed in service;³²

30. Note that the Housing and Economic Recovery Act of 2008 permits recycling of certain bond proceeds; as a result, it is possible to repay a bond loan and then the issuer can re-use the bonds for a non-LIHTC multifamily project. Thus, the date of repayment of a bond loan may not always be the same as the date of the bond redemption.

31. We note that the guidance summarized in Options 1 and 3 below were issued prior to the Housing and Economic Recovery Act of 2008, which permits repayment and recycling of certain bond proceeds. Prior to this date, the bonds would have been required to be redeemed. As a result, the guidance refers to bond redemption rather than bond repayment.

32. PLR 200147010.

- Option 2: Repay the bond loan after placement in service *and* after the 50% Test is met, but prior to the end of the first year of the credit period;³³ and
- Option 3: Repay the bond loan after the end of the first year of the credit period *if* the 50% Test was met after the project was placed in service *and* prior to the end of the first year of the credit period.³⁴

Projects with multiple buildings can create issues and caution should be used.

Example 4—Multiple Buildings

Assume that the transaction is structured to have a bond loan be partially repaid as each building is placed in service. Continuing with the facts of Example 3, \$2,625,000 of the \$10,500,000 of bonds could be borrowed and used to complete a building with an aggregate basis of \$5,000,000. Then the bond loan is paid down before another \$2,625,000 of bonds are drawn again for Building 2. The process is repeated for all four buildings. Based on the above rulings, the authors recommend not using such a structure and instead suggest that no part of a bond loan should be repaid until all of the buildings have been placed in service. None of the rulings approved of such a situation with early paydowns of loan. The authors feel there is risk that if bond proceeds are borrowed as described above, this would be more like a \$2,625,000 revolving line of credit rather than a loan of \$10,500,000. If the bond loan were considered to be only \$2,625,000 revolving line of credit rather than a \$10,500,000 loan, the project would not meet the 50% Test for each building.

4. Bond Issuance After Construction Begins

In some states, issuers utilize “pooled” bond issuances for multiple projects at set dates throughout the year. A particular project utilizing funds from that bond issuance may be on a tight construction timeline that requires construction to begin prior to the issuance of the bonds. In some instances, a building may be placed in service before the bond issuance takes place. While parties may be hesitant to begin construction until the bond issuance has taken place, delay of the issuance of bonds does not necessarily mean that costs incurred prior to the issuance cannot be included in the 50% Test. If costs can be reimbursed by bond proceeds within the relevant time periods set forth in the Code, those costs can be included in the 50% Test. We note that generally expenditures occurring earlier than sixty days prior to an inducement resolution for the tax-exempt bonds cannot be reimbursed with bond proceeds.³⁵ In addition, the reimbursement must occur on or before eighteen months after the later of the date the expenditure was paid

33. PLR 201049018.

34. PLR 199912023.

35. Treas. Reg. § 1.150-2(d)(1).

or the date the property was placed in service (but not later than three years after the original expenditure).³⁶ Therefore, a delayed bond issuance could be worked with if construction expenditures incurred within the reimbursement window through the end of the first year of the credit period for the first building placed in service would be sufficient to satisfy the 50% Test with respect to the building placed in service that year.

Example 5—Delayed Bond Issuance

Assume the facts set forth in Example 3, but with the following additional facts. First the tax-exempt bonds will not be issued until November 2024. Second, the land was purchased in January 2024, and construction began immediately thereafter. Third, Building 1 is completed and leased up in October of 2024, and \$4,000,000 of hard costs have been expended by such date. Finally, the bond documents permit tax-exempt bond funds to reimburse the borrower for expended costs prior to the bond issuance.



PLR 199912023 had a similar situation where construction financing was used to acquire land and construct a building. The building was placed in service, and the rehabilitation work was almost finished. After placement in service, but prior to the end of the year, which was the first year of the credit period, a permanent loan of tax-exempt bond proceeds was made to the taxpayer. Those funds were used to repay the construction financing. The facts also provided that the bond loan would be outstanding at the end of the year of placement in service. The IRS concluded that the land and building were financed by the tax-exempt bond loan despite the building being placed in service before the loan was made.

PLR 199912023 can be combined with PLR 201049018 for this Example 5. In this way, the bond loan could be used to not only pay for prior acquisition and construction costs, but it could also be used to pay additional good costs that would be incurred prior to the end of the year. For example, a building could be placed in service, but not all of the general contractor

36. Treas. Reg. § 1.150-2(d)(2). Note this is often utilized to reimburse costs in the event an operating building is purchased for rehabilitation.

fee may yet be due.³⁷ Based on the conclusion of PLR 201049018 that bond proceeds may be spent after the placement in service of the building but before the end of the first year of the credit period, bonds spent by yearend on such additional good costs can be utilized in the 50% Test. Since Building 1's credit period starts in 2024, assuming that an inducement resolution had been timely issued, the project can utilize the bond proceeds to reimburse the partnership for expenditures made prior to December 31, 2024, and still include those costs in the 50% Test in 2024. So long as the pooled bonds are issued and expended prior to December 31 of Year 1, any good costs expended during Year 1 could be included in the 50% Test for Building 1.

III. Conclusion

This article illustrates several important points about the application of the 50% Test to projects with complex facts. Critical things to remember are:

- (1) Do not repay a bond loan until all buildings are placed in service.
- (2) Do not repay a bond loan until the 50% Test has been met for all buildings.
- (3) For projects with multiple buildings placed in service over more than one year, make sure to analyze the 50% Test for those early buildings and account for bond proceeds that may be allocated to other buildings under construction.
- (4) Avoid, if possible, allocating bond proceeds to Bad Costs as that might impair your 50% Test.
- (5) For projects on a tight construction timeline, but where bonds have not yet been issued, consider beginning construction prior to bond issuance and reimbursing costs with the bond proceeds when issued.

³⁷ This could occur if a portion of contractor profit and overhead under the construction contract cannot be paid until the architect has issued the certificate of completion for Building 1 (assuming that the construction contract calls for profit and overhead to be earned when paid). The architect may be able to provide such evidence in December 2024 and the overhead and profit are then paid (which is after the placement in service of Building 1 in October).

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