What is the “95-5” Test?

WHITE PAPER

Prepared by:
Alison Hickman, Reznick Group

August 2012

What is the “95-5” Test?

Developers of projects that include a tax-exempt-bond–financed first mortgage are familiar with the requirement to provide a Borrower’s Tax Certification and the associated calculations commonly referred to as the “95-5” Test. A successful 95-5 Test will demonstrate compliance with certain sections of the Internal Revenue Code (IRC) of 1986, as amended, including Sections 142 (a) and 147 (b), (c), (d) and (g), which prescribe some of the factors for determining if interest income on the bonds will be excluded from gross income for federal income tax purposes. If it is determined that the project’s uses of bond proceeds qualify the bonds as tax-exempt, the project may also be eligible for 4 percent low-income housing tax credits, as authorized under IRC Section 42.

The 95-5 Test is typically submitted as an agreed-upon procedures report and included with the borrower’s Tax Certification preclosing document. The borrower and architect are responsible for completing Parts I, II and III of the Borrower’s Tax Certification. An accountant completes Parts IV, V and VI of the Borrower’s Tax Certification in the agreed-upon procedures format. After cost certification, a final 95-5 Test may also be required.

The 95-5 Test refers to the calculation of qualified and unqualified costs as percentages of tax-exempt bond proceeds; 95 percent of tax-exempt bond proceeds must be expended for qualified costs. The “Expected Use of Bond Proceeds” section of the 95-5 report contains the analysis of qualified and unqualified costs. Qualified costs are generally depreciable costs related to construction or development of the project. Land acquisition costs representing less than 25 percent of bond proceeds are also qualified costs.

Unqualified costs include most costs other than land and depreciable costs, although some depreciable costs are considered unqualified, such as fees for construction financing and certain accounting and legal fees. Fees that represent profit to a related party are unqualified. Generally expenditures cannot be made more than 60 days before the date of official intent. Excluded from this category are preliminary expenditures related to architectural, engineering, surveying, soil testing and similar costs.

Official intent is the bond issuer’s formal notification that it has reviewed and preliminarily approved issuance of tax-exempt bonds for a project, typically in an estimated amount that will allow room for fluctuation until final costs are determined.

Land costs equal to or more than 25 percent of bond proceeds and costs of issuance exceeding 2 percent of bond proceeds are unqualified. For purposes of the 95-5 Test, costs of issuance are usually considered entirely as unqualified, regardless of the total percentage.

Typically, the developer fee is classified as an unqualified cost, although there are certain situations in which the developer fee may be included in qualified costs. If the developer fee is needed in the qualified cost category to meet the 95-5 Test, it must be carefully examined to determine that it does not represent profit to a related party of the borrower.

The borrower will need to provide the accountant with the development budget, inducement resolution or declaration of official intent, average maturity of the bonds and, in the case of acquisition and rehabilitation, an appraisal stating the as-completed remaining expected useful life of the property. An appraisal is not required for new construction because the remaining expected useful life for purposes of the 95-5 Test is assumed to be 40 years.

Qualified assets are classified under depreciation categories as building, equipment, appliances or land improvements, and an average economic life of the assets is determined. Land is excluded from this calculation because it is not depreciable. Once the average economic life of the assets being financed is determined, the average maturity of the bonds as a percentage of the average economic life is calculated. The average maturity of the bonds cannot exceed 120 percent of the economic life of the assets being financed.

Bond counsel typically requires a draft report before issuing the Preliminary Offering Statement (POS). A final report is required at initial closing. Often, the budget fluctuates to some degree between the draft and final report, giving the borrower and bond counsel the opportunity to make changes and modifications as needed. A final updated 95-5 Test is typically completed after cost certification.

Additional considerations

Housing projects that are financed by tax-exempt bonds and use the 4 percent low-income housing tax credits have additional IRC considerations, especially when the project involves acquisition and rehabilitation. IRC Section 147(d) requires that rehabilitation expenditures equal or exceed 15 percent of acquisition costs. The substantial rehab test for Section 42(e) is different, requiring the greater of 20 percent of the adjusted basis of the acquisition cost of the building or $6,000 per unit, adjusted for inflation.

The tax credit investor often will require that a 50 Percent Test demonstrating compliance with IRC Section 42 (h) be issued concurrently with the 95-5 Test. The 50 Percent Test calculates the percentage of aggregate basis financed with tax-exempt bonds. If 50 percent of aggregate basis is financed with tax-exempt bonds, then 4 percent low-income housing tax credits will be awarded, as of right, on 100 percent of the tax credit basis. If less than 50 percent of the aggregate basis is financed with tax-exempt bonds, only that percentage will receive 4 percent tax credits. It is interesting to note that properties that significantly exceed the 95-5 Test often have a lower margin on the 50 Percent Test, or may even necessitate issuance of short-term tax-exempt bonds to meet the 50 Percent Test.

For more information, please contact Alison Hickman at Reznick Group by email at alison.hickman@reznickgroup.com or at (410) 895-7268.

This publication contains only general information and is not intended by Reznick Group to be a rendering of accounting, business, financial, investment, legal, tax or any other professional advice or services. This publication is not a substitute for any professional advice or services.