Spotlight *on* Capital Resources:

New Markets Tax Credit Program Extension

This publication is the third in a series published by Capital Link to inform health centers about the New Markets Tax Credit program and how they can potentially use it as part of a financing strategy for a capital project. In 2012, Capital Link published ***Spotlight on Capital Resources: New Markets Tax Credit Program***, which provided a basic program description and an example of how such a transaction might be used to finance a capital project for a Federally Qualified Health Center (FQHC or health center). In 2014, Capital Link published ***Spotlight on Capital Resources: New Markets Tax Credit Program Update***, which described how to qualify for the program under a specialized Targeted Population criteria (instead of census tract-specific poverty statistics) and the steps required at the end of the seven-year tax credit period for health centers to realize the full benefits of the tax credits. Health centers unfamiliar with the NMTC program can access the two prior publications at www.caplink.org/resources/publications.

This document will focus on the latest developments in the NMTC program, particularly for health centers interested in financing and constructing qualifying projects in the next several years. The topics include:

- The implications of the recently announced five-year **NMTC program extension**;
- The **steps in preparing to utilize NMTC** for your project (including a discussion on new constraints on the use of the "One Day Loan" structure), and
- The **feasibility of using a "Developer Fee"** in the transaction to increase investment in your project.

A Brief Review of the NMTC Program

To summarize the program benefits for those who need a quick refresher:

New Markets Tax Credits is an economic development program administered by the CDFI Fund under the U.S. Department of the Treasury. The program was designed to stimulate private investment in low-income communities by enticing investors to provide capital to Community Development Entities (CDEs), organizations focused on providing financing to economically distressed areas, in exchange for federal tax credits. The CDEs, in turn, lend or invest this capital into businesses located in targeted census tracts to spur economic growth. Since the NMTC program's inception in 2000, many FQHCs have utilized this powerful but complex financing tool to their advantage – some for more than one project, and at least one FQHC for three separate projects. This is due, in part, to the fact that many health center projects qualify as low-income community businesses because the census tract-based qualifying criteria for NMTCs are often very comparable to the service areas for FQHCs established by the Health Resources and Services Administration (HRSA).

Health centers interested in pursuing NMTC should determine whether the select demographic statistics of the census tract in which their project is located make it Eligible or (preferably) Highly Distressed according to the thresholds noted in the table below.

Census Tract Criteria	Eligible	Highly Distressed
Poverty Rate	>20% or	>30% or
Median Family Income	<80%	<60% or
Unemployment Rate	N/A	1.5x the national average

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Most NMTC transactions are structured so that all, or a portion, of the investor's original investment becomes equity to the health center at the end of seven years through a structure often referred to as "the leverage model." NMTC transactions typically structure the entire financing for the project as two or more, below-market, interest-only loans during the seven-year tax credit period. In the end, the loan associated with the investment portion does not need to be repaid. A health center project that qualifies for NMTC can often secure approximately 20-22% of its total project costs through this type of financing, thereby reducing the amount of additional fundraising or borrowing by this amount.

In some cases, the NMTC investment represents the 20% minimum equity frequently required by lenders to participate in a commercial real estate transaction.

NMTC Program Extension

Until recently, the New Markets Tax Credit program was one of several tax credit programs (including those for low-income housing, research, and renewable energy) that required annual approval and appropriation through the federal budget process. As even a casual observer of Congress will appreciate, this exposed the program's funding to long delays and high levels of uncertainty every year. One result of these repeated delays was that the date of the award announcements was pushed back several times, such that the 2015 awards have yet to be announced in the fall of fiscal year 2016.

In December, 2015, the situation changed when Congress approved the program for five more years (2015 -2019) at an annual appropriation of $3.5 billion. While the program is still not permanent (a goal that community development experts have long been seeking), this extended authorization provides a welcome degree of certainty to the industry and to those organizations planning on using NMTC for their capital projects. Now, a health center with plans for a new capital project will have the time to find and secure a site in a qualifying census tract and, if necessary, conduct a multi-year capital campaign with reasonable confidence that credits will be available when the project is ready for financing. Assuming the chosen project site is in a "Highly Distressed' census tract, the chances of securing credits in the year the health center is ready to begin building are significantly higher. Centers can approach multiple funders early on with their capitalization plan, and including a projected NMTC investment can help convince foundations and bank lenders of the project's readiness and that the health center's ability to fully fund it are realistic and reasonable. That said, the NMTC process remains competitive and health centers should not become complacent and assume funding is secured until the project planning is complete and a NMTC reservation letter from a CDE is in hand.

Another substantive change resulting from the extension legislation impacts the short-term availability of NMTC allocation. The CDFI Fund announced that in order to remedy the aforementioned delay in the award process, the 2015 and 2016 rounds will be combined for a total of $7 billion in tax credit allocation. These combined awards will be announced in late 2016 from the existing pool of applications that were submitted last year for the 2015 round, so there will be no unique 2016 application process. For health centers, it is important to note that:

- CDEs apply for allocation, so health centers haven't missed any application deadlines. Health centers need to find a CDE willing to help finance their project when it is ready.

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- The large amount of allocation, expected to be awarded late in the 2016 calendar year, should make it easier to secure credits for qualifying projects.
- With the delay in the 2016 award announcement, FQHCs prepared for the current allocation cycle have more time to get their projects ready to present to CDEs (provided they accommodate changes in regulations affecting the One Day Loan, described below) while those close to being ready might be able to accelerate their planning efforts and not have to wait another full year.

If your project is ready now, there may be credits still available from the 2014 award cycle. The chances of securing these credits will be better if the project is in a non-metro area (in any state) or is located anywhere in the ten states that have been identified by the CDFI Fund as being under-represented in the utilization of NMTCs. Those ten states are: Alabama, Florida, Georgia, Idaho, Kansas, Nebraska, Nevada, Tennessee, Texas, and West Virginia (as well as Puerto Rico). If you have a project located in one of these states/territory, there is no guarantee that credits will be available for it, but several CDEs applied for (and were awarded) credits based on their promise to place a high percentage of their award in those areas. Promises that CDEs make in their applications are documented in their Allocation Agreements with the CDFI Fund, so it is possible some CDEs may still be looking for transactions in these areas.

Given the delayed timing of the next round of awards, health centers with potential qualifying projects should prepare now to attract NMTC allocation to their project. If you need help or have specific questions about NMTC, Capital Link can help guide you through the steps.

Preparing to Utilize NMTC

Check Project Qualification	The first priority is to be certain the project qualifies for financing through the NMTC program. While the CDFI Fund is the final arbiter on project qualification, their mapping function is designed for use by CDEs.
Capital Link advice	Go to the Novogradac & Co. website to use their mapping tool, (www.novoco.com/resource-centers/new-markets-tax-credits/data-tools/nmtc-mapping-tool) enter the address of the project, and look for the color coding by census tract or zip code. Red indicates Highly Distressed, which is good for NMTC purposes and will make your project more attractive to CDEs with available tax credit allocation. If your project address is not shaded red, refer to our second NMTC Update and read up on potentially utilizing "Targeted Populations" criteria to qualify or contact Capital Link for potential options.

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Preparing to Utilize NMTC

Build Initial Sources and Uses of Cash Statement	Once you have determined eligibility, build an initial sources and uses of cash statement to help you determine how much benefit the NMTC investment will be so that you can calculate how much funding you need to secure from other sources. Creation of the sources and uses statement is discussed in our first NMTC publication, but it is important to emphasize two elements: 1. Calculating the amount of the tax credit, and 2. Accounting for project costs you've already paid for (the "One Day Loan").
3. Determine the NMTC Investment	The amount of this investment is calculated from total project costs, so start by creating the uses of cash statement. No matter how early it is in the planning process, it is not difficult to estimate real estate costs, hard construction costs, equipment and fixture costs, soft costs (architect, engineering permits, insurance etc.) and closing costs by following the advice below. To determine the amount of your expected NMTC investment, multiply the total uses by 39% (the amount of the tax credit subsidy) and then multiply that amount by $.85 (current market price as of June, 2016 that investors are paying for $1 of tax credits – it can vary over time). For example, if your total uses of cash came to $10,000,000, you should expect that the NMTC investor will provide $3,315,000 of project financing ($10,000,000 x .39 x $.85).
Capital Link advice	If you don't already own/control the site, talk to a local real estate firm and ask them for an approximate price for an existing building of the size you are looking for, or a lot large enough to fit the prospective clinic within the target service area. Be sure to ask them about local parking requirements. Talk to a local architect about current construction costs (especially if you can find one that already has experience with medical buildings). Ask for an approximate per-square-foot hard construction cost as that allows you to modify the project size early on without constantly going back to the architect for another estimate. Ask for a conservative figure; it is always better to revise costs downward later on than to have to find more money to pay for cost over-runs.

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Preparing to Utilize NMTC

Capital Link advice

Once you have a total hard cost figure (projected total square footage of the project times per square foot cost):

1. Use 15% of Hard Cost for Furniture, Fixtures and Equipment. Adjust down if you know you are transferring a substantial amount of FF&E from an existing facility or up if the new facility has a large dental component;
2. Use 12% of Total Hard Costs as an estimate for Soft Costs;
3. Use 10% of the sum of all other costs as a rough approximation for Closing Costs and Capitalized Interest (yes, that seems high but in the end the investor is paying for it. While these costs reduce the total benefit of using NMTC, they do not require more cash out of the health center's pocket).

3. Determine Your Funding Strategy

Once you know the value of the tax credit portion of your project financing, you need to come up with a strategy for raising the rest of the funds—either through health center cash, grants, a capital campaign and/or one or more loans.

Capital Link advice

For this purpose you generally need a business plan and, if you are seeking a loan for a portion of the project, financial projections that show you can repay the loan. To the extent your business plan and financial projections are ready when tax credit awards are announced, your project will be viewed more positively by CDEs with credits. For more information on developing a funding strategy, access our capital project financing resources at www.caplink.org/resources/publications.

The "One Day Loan"

When putting together your uses of cash statement, be sure to include the cash value of any project-related assets that the health center has already purchased or expenses incurred. The offsetting entry in the sources of cash statement is referred to as the "One Day Loan". This entry is an important aspect of most NMTC transactions, but a recent regulatory change has influenced how to account for these costs. It goes without saying that capital projects take time to complete, usually a lot of time. As a result, it is almost impossible to align the timing of:

- The acquisition of a well-located property;
- The conclusion of a long-term capital campaign;
- A variety of foundation (or HRSA) capital grant cycles, and
- A bank loan underwriting process.

All of these are important elements of most capital financing plans.

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If only the costs yet to be paid could be included in a NMTC transaction, the amount of tax credits awarded to the health center would be significantly reduced, as the investment is determined by the total project costs. The ability to monetize portions of the total capital project that were acquired or paid for prior to the closing of the construction financing allows for the inclusion of ALL capital costs in the NMTC transaction, thereby maximizing the amount on which the investor's contribution to the project is calculated. This reduces the amount that the health center has to raise or borrow, which is clearly a significant benefit to the organization. A recent regulatory clarification has decreased the window of time in which project costs can be incurred and still count as part of the total project costs. Impacted costs most often include the land, environmental review, and early planning expenses such as architect fees for initial schematics and/or draft floor plans. Two caveats here:

1. **Be sure that the costs are project-related, and**
2. **Be sure that the assets were purchased within 24 months of the projected closing date.**

The next question is obvious: ***"How do I know when that will be?"***

Capital Link advice

Determine when the next round of awards is scheduled to be announced (probably November). If your project planning and other fundraising will be substantially completed by then, **add 6 months to that date**. Any project costs paid for 24 months or more prior to this projected date cannot be included in the sources and uses statement.

This 24-month safe harbor "look-back" provision is a relatively new clarification to remedy an ambiguous part of the NMTC program. Previously, all identifiable project costs could be "monetized" at closing through the one day loan mechanism. To the untrained observer, however, the idea of a loan that is issued and repaid in one day and that results in an increase in the tax credit generated to a third party investor seemed highly contrived and controversial. In response to this specific criticism, the CDFI Fund established the "look-back" provision for qualifying project-related costs.

Capital Link advice

If you are contemplating the purchase of a property for a project but don't anticipate having the balance of the project funding secured for 12 to 18 months, see if you can secure an option to buy the property at a future date (clearly this only applies if the property is expensive and the tax credits to be generated by including the asset in the financing are substantially above the cost of the option).

While the look-back" provision is not optimal for health center capital projects in general, it is better than the alternative, an outright prohibition on the use of one day loans. Also, the limited look-back does make health centers focus on the pace of project planning and could possibly be used to incent funders to commit their support more quickly.

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Developer Fee

In the interests of maximizing the total project-related costs of a health center capital project and thereby maximizing the amount of investment generated by the NMTC transaction, there is an infrequently used stratagem in which the health center can use a “developer fee”. A developer fee is compensation to the health center for all the staff time used throughout the project planning and construction period. Since independent property developers typically charge such a fee to clients for building construction, its use is not unique to NMTC transactions. The specific circumstances whereby a develop fee can be advantageous are:

- **The health center is the primary developer of the project.** This is the case with the majority of NMTC projects with which Capital Link has been associated. As a rule of thumb it is only NOT the case when the center has agreed to lease a portion of a building from a developer who is building the building themselves using NMTC for a portion of the financing. Since the majority of health center sites are owned and operated by a health center (or an affiliated subsidiary) most projects should pass this test.
- **The health center or its consultants can identify CDEs with NMTCs in excess of the total project costs identified through the sources and uses statement.** Many FQHC projects struggle to find credits to match the full project costs but on occasion a CDE has more credits remaining than the project needs. For instance, a CDE has $10 million in remaining NMTC allocation but the applicant’s total project cost is only $9 million. The minimum project size to attract NMTC is generally considered to be $5 million because of the high costs of closing costs, so a CDE with remaining tax credit allocation less than this amount may have trouble placing it.
- **The health center has cash or excess grant revenue to make up all or a substantial portion of the unsubsidized developer fee.** Using the example above, it must be recognized that by increasing the total project costs by a $1,000,000 developer fee, the health center generates another $330,000 of NMTC. But the full $1,000,000 cost must be financed up front, so the center would need to borrow the $670,000 difference if it does not have that much excess cash to contribute or a grant source for it. While the full fee will eventually be paid back to the center, the costs of financing it if another funding source is not available can make it uneconomical to pursue.

One last note on the developer fee: Most NMTC lawyers will balk at allowing the health center to charge a developer fee in excess of 10% of total project costs. Anything below that amount should be non-controversial.

Conclusion

The benefits of NTMC financing to a health center capital project are clear, but the path to realizing those benefits can be rocky. The recent program extension provides health centers that have qualifying capital projects with more time to plan and more certainty in the next few years that allocation will be available to them when they are ready. However, an important change in “the one day loan,” the typical methodology for accounting for project costs paid prior to closing, could reduce the benefits of NMTC financing realized by health centers whose projects are slow to come together.

Contact Jonathan Chapman, Director of Community Health Center Advisory Services, at jchapman@caplink.org for assistance in determining whether the NMTC program could be a good fit for your health center.

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About Capital Link

Capital Link is a non-profit organization that has worked with hundreds of health centers and primary care associations for over 15 years to plan capital projects, finance growth, and identify ways to improve performance. We provide innovative consulting services and extensive technical assistance with the goal of supporting and expanding community-based health care. For more information, visit us at www.caplink.org.

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