New Markets Tax Credit Program

What is the New Markets Tax Credit Program?

In 2000, Congress passed legislation creating a new economic development tax credit program called New Markets Tax Credits (NMTC). This tax credit was designed to stimulate private investment in low-income communities. The program is administered by the Community Development Financial Institutions (CDFI) Fund under the US Department of the Treasury.

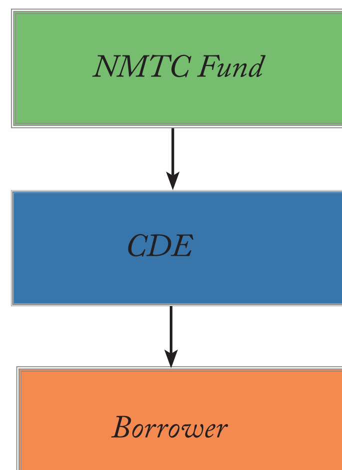
Through a series of competitive application cycles, the CDFI Fund allocates tax credits to Community Development Entities (CDEs). As organizations focused on providing financing in economically-distressed areas, CDEs work to attract investors (primarily banks and large corporations) to provide them with capital in exchange for federal tax credits. The CDEs, in turn, lend or invest this capital in businesses located in targeted census tracts to spur economic growth.

Because the service areas of many federally qualified health centers ("FQHCs" or "health centers") overlap these specific census tracts, health centers can often qualify to utilize NMTC investments as part of their capital financing. NMTC transactions typically provide below-market, interest-only loans during the seven-year tax credit period; most transactions are also structured so that all or a portion of the original investment amount can become equity to the health center at the end of year seven—in effect, the NMTC portion of the investment does not need to be repaid.

That's interesting, so how does it work?

Non-profit tax exempt organizations such as FQHCs typically think they are not eligible to participate in tax credit programs such as NMTC—but a structure has been developed that allows them to benefit. NMTC structures are complex and can be intimidating for health center boards and staff. However, by focusing on the real benefit that accrues to the health center and its capital project, boards and staff can successfully work through the intricacies of the program details for a very favorable financial outcome.

NMTC transactions generally involve three levels: (1) the Fund level; (2) the CDE level and (3) the Borrower level, expressed graphically like this:



© 2012 Capital Link. All Rights Reserved

Capital Link

New Markets Tax Credit Program

Let's review each level:

NMTC Fund Level

The Fund is a for-profit organization generally created specifically for your capital project. In a "leveraged" NMTC transaction, the Fund is owned by an equity investor (such as a bank) who contributes capital to the deal. In order to leverage this capital, the Fund goes out and uses that commitment of equity to borrow additional funds sufficient in total to pay for the capital project and all associated fees and costs. Some of those funds may come from the health center itself in the form of capital campaign proceeds, capital grants, cash reserves, and/or various loan proceeds from private or public lenders. It is important to note here that all of the equity that the health center has raised is loaned to the Investment Fund, assuming sufficient tax credit allocation is available for the project. Most health centers typically see grant dollars as reducing the net financing requirement for a project. However, within a NMTC structure, all valid project costs should be included so that the amount of tax credit benefit thus generated is maximized. This is a very important (if somewhat counterintuitive) element of the NMTC program!

The Investment Fund now takes the combined equity and loan capital it has secured and invests it into the CDE that is interested in your project in return for those tax credits. This investment is called a "Qualified Equity Investment" or QEI.

CDE Level

The CDE receives the QEI from the Fund and allocates tax credits equal to 39% of the QEI to the Fund. Then the CDE turns around and pays all the closing costs and fees and loans the balance of the funds to the borrower, known in these transactions as the "Qualified Active Low-Income Community Business" or QALICB.

Borrower Level

The health center itself, or a "Special Purpose Entity" set up by the health center acts as the QALICB and functions as the Borrower during the seven year tax credit period. As the owner of the building, the QALICB borrows the funds from the CDE and uses these funds to build or renovate the new health center.

Over the seven-year tax credit compliance period, the QALICB makes interest and fee payments to the CDE. After keeping a portion of the QALICB's payment to cover its costs, the CDE passes the rest up to the Fund. The Fund pays debt service on the loans at the Fund level (which may include interest payments to the health center itself, if the health center is a leverage lender to the Fund).

© 2012 Capital Link. All Rights Reserved

You are right, it is interesting AND confusing…can you give me an example of how this might work?

Let's consider a theoretical $10 million project, including construction hard costs, soft costs and equipment, located in a qualifying census tract. As discussed above, the NMTC process is able to attract investors to the CDE because of the tax benefits the CDE can offer. In this example, based on the current market, we assume an investor will invest approximately $2.8 million in the project in exchange for approximately $3.9 million in tax credits it can claim over the seven year tax credit period (5% in the first 3 years and 6% in the final four). The return on investment thus generated is sufficiently attractive that the investor does not require the return of its investment at the end of the seven years—and indeed tax accounting rules actually incent the investor to rid itself of the investment. While tax law prohibits the terms of the loan to the QALICB/health center to be specifically "forgivable", the health center as borrower has put/call rights in the ownership of the Investment Fund, which ultimately gives it control over the disposition of the net investment dollars (we said it would start getting complicated!).

Now, clearly the $2.8 million from the investor is not sufficient to build a $10 million project. The purpose of the NMTC program is to leverage other sources of capital investment into low-income areas. In order to fund the whole project, the remaining $7.2 million (72%) must be leveraged from other sources. These funds typically come from capital grants, health center cash reserves and/or a loan from a bank or Community Development Financial Institution. As noted above, if you already own the land on which the project will be built, the value of the land should be included in the transaction (the higher the valid project costs, the more the tax credit benefit). Project expenses that you have already paid (i.e. architects, engineers, etc.) should be treated the same way. In the example, we assume the health center owns the land (valued at $1,000,000) and is investing $1,000,000 of its cash as project equity.

Before you can put together an initial Sources and Uses of Funds statement, you must also take into consideration the fees charged by the CDE/lender to put together the NMTC financing and the associated closing costs. These fees can be substantial depending upon the complexity of the transaction (large projects usually require more than one CDE; projects that include housing or commercial rental space will add to closing costs as well). Because of these significant fees/costs, your capital project should exceed $5 million in total costs—otherwise, the net benefit of the tax credits is not significant enough to warrant the work required to close this type of complex financing. For our example, the closing cost/fee estimate for a $10 million project can be as much as $1 million.

One last additional cost (which you'll need to consider whether you use NMTC or not) is capitalized interest, which is the amount of interest payments to be made on the debt during construction. You certainly do not want to be using operating cash to make debt service payments before the project is completed and generating cash on its own.

© 2012 Capital Link. All Rights Reserved

New Markets Tax Credit Program

So, let's expand the example. The Uses of Cash statement below sets out the total estimated costs of the project and associated NMTC financing.

Uses of Project Cash	Amount
Land Value	$1,000.000
Hard Construction Costs	$7,500,000
Soft Costs	$1,500,000
Furniture & Equipment	$1,000,000
Closing Costs	$1,000,000
Capitalized Interest	$ 400,000
Total Project Cost:	**$12,400,000**

The following Sources of Project Cash table displays just one example of how the project might be financed:

Sources of Project Cash	Amount
Value of Owned Land	$1,000,000
CHC Cash Reserves	$1,000,000
Capital Grants (incl. HRSA)	$5,000,000
Leveraged Loan	$1,918,000
NMTC Equity*	$3,482, 000
Total Project Cost	**$12,400,000**

* NMTC equity increased from original example because of higher Total Project Cost

As can be seen in the tables, the net benefit of the NMTC to this transaction is approximately $2,482,000 ($3,482,000 in NMTC equity less NMTC Closing Costs).

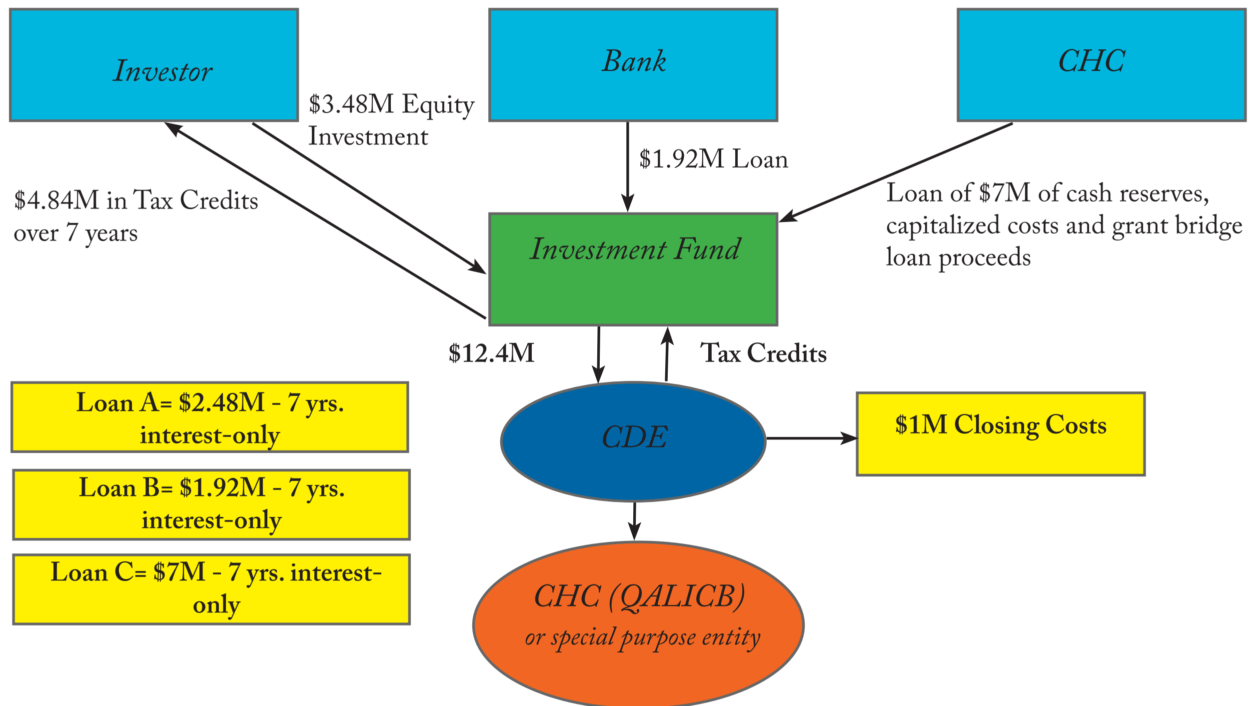
As noted in the summary, the CDE now takes the Qualified Equity Investment it received from the Investment Fund ($12.4M), pays the closing costs ($1M) and then makes a series of loans to the health center (or Qualified Active Low-Income Community Business – QALICB – in NMTC jargon). Each loan will have its own interest rate. Loan "A", the amount of which is equal to the Investor's net investment, usually carries an interest rate of approximately 2% per annum. Loan "B" represents the leveraged Lender's debt and carries whatever interest rate is agreed to with the bank or lender. In our example the grants and cash that the health center brings to the transaction are structured as a Note "C", which usually carries a 1% interest rate (the rate is not too important to the health center since it ultimately receives the interest paid on this note back at end of each month). Sometimes the interest rate on all three loans at the QALICB level is actually the same, but it's calculated as a blended rate derived from each constituent source of capital as discussed above.

© 2012 Capital Link. All Rights Reserved

New Markets Tax Credit Program

At closing, all note proceeds are deposited into a Construction Account. Note that the construction account works in reverse to the typical construction loan – it starts fully-funded and is drawn down as opposed to the more typical Construction Loan which starts from $0 and increases as the project is completed. The result is that the Construction Account may have funds left when the project is completed – but these can be drawn down to make ongoing monthly interest payments on the NMTC loans.

Now let's examine the whole process in a diagram:



As your NMTC transaction moves forward and the specific CDE, Investor and Leveraged Lender(s) are identified, you can be certain there will be changes to this basic structure. The NMTC regulations and related tax law are too complicated to go into in depth here, but you can be sure you will learn things about the tax code during the NMTC closing process that you did not know before (you can decide if that's a good thing!).

So, what happens after 7 years?

As noted, the New Markets Tax Credit period lasts for seven years. At the end of that period, through a "put/call agreement" the QALICB (the health center) basically buys the investor's interest in the Investment Fund for a nominal amount (frequently as low as $1,000). At this point the health center owes the principal balances of Note A to itself, so the note is liquidated and the principal balance become equity to the health center. The same thing happens to Note C, which represented the health center's grants, cash equity and capitalized expenses at the start of the project. The principal balance of Note B is still owed to the bank or lender – and often is due in full after the seven year period. That does not mean that the lender will not renew the note and keep the capital in the deal but usually they want to keep their options open. In any event, the health center will know about this maturity event well in advance and will have seven years to arrange take-out financing or (even better) to raise grant funds to pay it off.

© 2012 Capital Link. All Rights Reserved

New Markets Tax Credit Program

It is very important to note that during the seven year tax credit period, principal payments are generally NOT ALLOWED – it creates tax credit recapture risk for the investor so most CDEs prohibit pre-payment. That does not mean that you cannot create what is known as a "sinking fund" – a savings account that is used to pay down principal after the tax credit period. Some lenders may even require it. Keep in mind that interest-only payments have the benefit of minimizing your out-of-pocket financing expenses during the new clinic's crucial early ramp-up period.

Now, let's compare conventional financing to NMTC Financing.

Conventional Loan: Assume the same example as used above, but for a conventionally financed deal there will be no NMTC closing costs, no need to take the land value into account (you already own it) and all grants and cash are used to reduce the amount you need to borrow. The Total Project Cost will still be $10.0 million but the amount the health center needs to borrow is only $4.32 million (see table below). We will also assume the health center goes to a bank or other financial institution and obtains a 20 year commercial real estate loan in that amount at the current market interest rate of approximately 7%. Total principal and interest payments under this scenario would be approximately $8,043,500 over 20 years.

Commercial Bank Loan	Amount
Est. Total Project Cost	$10,000,000
CHC Cash Equity	$1,000,000
Grant Awards	$5,000,000
Net Project Financing Required	$4,000,000
+ est. Bank Closing Costs	$30,000
+ est. Bank Fee (@.25%)	$10,000
Capitalized Interest	$282,800
Total est. Loan Amount	$4,322,800
Est. Bank Loan Interest rate =	7.0%
Est. Bank Loan Amortization Period (years) =	20
Estimated Monthly Payment	$33,515
Estimated Annual Payment	$402,175
Total Cash Payments by Health Center for Project Financing	**$8,043,509**

NMTC Loan Structure: In the New Markets Tax Credit model, described on the next page, the blended interest rate on the three Notes is 2.21% for the entire seven year tax credit period. This structure would result in total payments of $1,917,300. At the end of seven years, we make the same assumption as above that the outstanding bank loan of $1,918,000 is amortized for another 13 years (total of 20) at 7%; resulting in additional principal and interest payments of $2,926,560. Altogether the cost of the NMTC transaction is only $4,355,926 over 20 years—a substantial savings over the conventionally-financed deal.

© 2012 Capital Link. All Rights Reserved

Capital Link

New Markets Tax Credit Program

NMTC Structure		Amount
Est. Total Project Cost		$11,400,000
Total - Grossed up for NMTC Fees		$12,400,000
Value of Land, Project Cash, Grants in Hand & Projected Grants		$6,000,000
Capitalized Costs		$1,000,000
Principal Loan A (Investor)		$3,481,920
Principal Loan B (Bank)		$1,918,000
Principal Loan C (CHC SPE)		$7,000,000
Total		$12,400,000
Loan A Interest Rate (Investor)		2.0%
Loan B Interest Rate (Bank)		7.0%
Loan C Interest Rate (CHC SPE)		1.0%
Blended Interest Rate	2.21%	
Initial Loan Term (all loans)	7 years	
Monthly Payments (1st 7 years)		$22,825
Principal Balance at end of 7 year NMTC period		$1,918,080
Amortization after NMTC period	13 years	
Monthly payment for remaining Amortization (Loan B only) @ 7.0%		$18,760
Total Cash Payments by Health Center for Project Financing		**$4,355,926**

I heard that HRSA capital grants can be used in conjunction with NMTC transactions. How does that work?

HRSA has released guidance describing its requirements regarding considering requests from health centers that wish to combine the benefits of NMTC financing with HRSA capital grants. While each grantee's situation may be unique, in general, HRSA requires that its grant funds can only be drawn as construction costs are incurred. By obtaining a bridge loan for the HRSA grant funds during construction, the health center can lend the bridge funds through the NMTC structure, thereby generating the tax credit proceeds needed for the project, and then draw on the HRSA grant funds as construction proceeds to repay the bridge loan. Each grantee must obtain HRSA's prior approval if it wishes to use HRSA grant funds in this way.

The advantages of the NTMC financing are clear. The low-rate, interest-only loans generate substantial cash savings during the first seven years of the project while the health center is ramping up its operations. Moreover, at the end of the seven year tax credit period, a significant portion of the financing is converted to project equity, thus reducing the health center's total debt burden for the project. While NMTC financing is complex, the benefits make it an attractive option for those projects that qualify. Contact Capital Link for assistance in determining whether your project is located in an eligible NMTC census tract and for help in evaluating whether this financing program could be a good fit for your health center.

© 2012 Capital Link. All Rights Reserved

New Markets Tax Credit Program

Acknowledgement

This publication was supported by Grant/Cooperative Agreement Number U30CS09741 from the Health Resources and Services Administration, Bureau of Primary Health Care (HRSA/BPHC). The contents of this publication are solely the responsibility of the author(s) and do not necessarily represent the official views of HRSA/BPHC.

About Capital Link

Capital Link, established in 1998, is a non-profit organization dedicated to assisting community health centers in accessing capital for building and equipment projects. From market feasibility and program, staff and facility plans to comprehensive financing assistance, Capital Link provides extensive technical assistance to health centers to strengthen their abilities to plan and carry out successful capital projects. Additionally, Capital Link works in partnership with primary care associations, the National Association of Community Health Centers and other entities interested in improving access to capital for health centers. For more information, visit www.caplink.org.

© 2012 Capital Link. All Rights Reserved