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An Attractive Alternative for Funding Expansion Projects

How Qualifying Providers Can Take Advantage of the U.S. Treasury's New Markets Tax Credits Program

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Health systems across the country are faced with the imposing realities and costs associated with the demands to increase market share and to keep up with the technology needed to serve their patients. In light of constant competing demands for capital dollars, funding new construction can be a significant challenge. Most systems are more familiar than they might like to be with traditional financing mechanisms such as taxable and tax-exempt bond issues, but for those who qualify there is a federal program run through the U.S. Treasury's Community Development Financial Institutions Fund (CDFI) that can be a very attractive alternative: the New Markets Tax Credits Program (the "Program").

Established in 2000, the Program was developed to encourage capital investment in low income communities. This encouragement takes the form of federal income tax credits called "new markets tax credits" or "NMTCs" allocated annually by the CDFI to Community Development Entities (CDEs) that apply for them. The allocation process is competitive and limited, but once a CDE is allocated the tax credits, that CDE is highly motivated to find projects to utilize them, particularly if the CDE intends to apply for another allocation the next year.

The process starts with a CDE that has been awarded NMTCs agreeing to participate in a project that qualifies for them. Once a CDE identifies a project and agrees to provide a certain amount of NMTCs to the project, it then connects with investors who are looking for the tax credits. Those tax credit investors will become equity owners of a single purpose entity (the "Investment Fund"); the Investment Fund then makes an investment in another single purpose entity (the "Sub-CDE") created by the CDE that has the tax credits; the Sub-CDE will in turn use the equity investment to provide financing (also referred to as "Qualified Low Income Community Investments" or QLICIs) to qualified borrowers — this is where the health system comes in — who are referred to as Qualified Active Low Income Community Businesses (QALICBs). The funds provided by the equity investor are typically combined with dollars loaned to the Investment Fund (and referred to as the "Leverage Loan"), with the sum of both the equity investment and the loan being invested in the Sub-CDE and loaned to the QALICB; the equity

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investor will receive tax credits on the total amount invested in the Sub-CDE (which will be equal to the tax credit allocation received from the CDE). Although there are several ways to qualify as a QALICB, the one most often used (and preferred by investors because it is easy to test), is that it be a business located in a low income census tract, as identified in the 2010 U.S. Census, based on poverty rates, median family incomes and unemployment rates. A corporation (including a non-profit corporation) or partnership can qualify as a QALICB if at least:

1. 50% of its gross income is derived from business activities in a Low Income Community (LIC),
2. 40% of the use of its tangible property is within a LIC, and
3. 40% of the services performed by its employees is in a LIC.

Assuming a CDE with NMTC allocation can be found by a qualified borrower having a qualified project, how would the loan itself be structured? Let's assume a hospital system needed $10,000,000 in financing to expand one of its medical office buildings located in a LIC. The loan structure would be as follows: A leverage lender would lend $7,000,000 to the Investment Fund, typically structured as a limited liability company (ILLC). The tax credit investor would contribute an equity investment to the ILLC of an additional $3,000,000. The investor would own 99.9% of the ILLC, and would receive the tax credits on the full $10,000,000. The ILLC in turn makes an equity investment in the Sub-CDE and the Sub-CDE makes two QLICI loans to the QALICB. Loan A would be a loan with a below market interest rate that matches the amount of the leverage loan. Loan B would be a loan that matches the amount of the NMTC equity. Both loans would be interest only.

Seven years is the magic number in these transactions because the investor will receive its tax credits over a seven year period – five percent for each of the first three years, and six percent for each of the remaining four years, for a total of 39% over seven years. Thus, in our illustration, the tax credit investor will receive $3,900,000 in tax credits (39% of a $10,000,000 total QLICI) over a 7 year period, an excellent return on its $3,000,000 investment. Once the investor receives all of its tax credits, the investor has the right to put its interest in the investment fund to the QALICB (or an affiliate thereof), typically at a nominal price. The expectation of the parties is that the investor will exercise this right, since the investor participated in the deal to obtain the tax credits rather than a revenue stream from loan payments, and the tax credits have been used up. As a result, the QALICB or its affiliate will own the entity that made the loans to the QALICB, and has every incentive to forgive Loan B, resulting, in a sense, in $3,000,000 of "free money" in the deal. Of course, it is not all "free money," as there are fees involved in putting the NMTC structure in place and additional costs involved in keeping it in place for 7 years, but at the end of the day, the net benefit to the hospital would be a significant portion of that $3,000,000 that does not have to be paid back.

There are a number of hoops to jump through to meet the Program's requirements and there are added complexities presented by the financing structure itself, including additional parties, all of whom require either a fee or a return on investment. Notwithstanding the additional complexity and fees, for a health system that is willing to be patient and to incur the additional transaction costs, this Program can provide significant financial support for capital improvements in a low income area. Those benefits could be maximized if the system has

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additional capital needs and is able to obtain additional allocation, thus taking advantage of transaction efficiencies. The key aim of the Program is to provide much needed investment into low income communities. Given the number of health systems and teaching hospitals serving low income urban and rural communities around the country, there are many opportunities. There are some CDEs that are looking specifically for investments in the health care sector, urban low income communities, or rural low income communities, providing multiple possible sources of allocation.

As an example, a certain unnamed public health system was looking to expand one of its facilities to the tune of a $160,000,000 expansion. Bond proceeds were available to finance much of the medical and clinical space, but at least one floor was going to need to be shelled until additional funds were made available to build out the space. In comes the New Markets Tax Credits Program. As a governmental entity, the health system did not qualify as a QALICB. However, this particular system has an affiliate that is a tax exempt corporation that did qualify. The solution was a condominium regime by which (i) the affiliate (QALICB), would own one floor of the building (which would be leased back to the health system) and (ii) the health system would own the remaining floors and other associated real estate. As a result, the system accessed the much needed additional funding for the construction and build out of the one floor of the building. There were additional upfront costs associated with the creation of the condominium, but this structure is now in place. The ongoing operation of the facility will be seamless, but floor by floor (or unit by unit) ownership of the facility was able to be tailored based upon the financing needs of the health system. The system now has a flexible and workable model for this facility and others, enabling it to pick and choose between tax exempt bonds, New Markets Tax Credits financing and other financing structures to meet its overall needs.

Yes, there are complexities, but the New Markets Tax Credits Program also presents some wonderful opportunities. It is a financing tool that certainly should be considered by any health system with a need to improve and expand capital assets in low income communities.

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