MEMORANDUM

To: Heather Peters, Housing & Community Development Specialist III, County of San Mateo Department of Housing

From: Benjamin C. Sigman, Darin Smith, and Paige Peltzer

Subject: Potential for New Market Tax Credits for Middlefield Junction; EPS #161117

Date: August 1, 2017
Updated for RFQ/P consistency on May 7, 2018

Economic & Planning Systems (EPS), as a subconsultant to Van Meter Williams Pollack (VMWP), is assisting San Mateo County (County) with master planning for Middlefield Junction. The Master Plan encompasses three parcels of approximately eight acres in total. The sites are located within the North Fair Oaks Community Plan area and have been identified as an ideal location for community services and housing.

While the master planning process is ongoing, the County has identified a near-term priority to develop a vacant parcel of about 3.2 acres. Known as "Parcel A," the property is within San Mateo County and is owned by the County. The site is adjacent to the Fair Oaks Health Center, which is run by the San Mateo Medical Center/San Mateo County Health System. The site also is bordered by single-family homes and train tracks.

Source: VMWP

The Economics of Land Use

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The County is contemplating issuance of a Request for Qualifications (or for Proposals) for development of a mixed-use below-market-rate housing project on Parcel A. The non-housing elements of the project are envisioned to be a child care center and another non-housing use, such a wellness center, community center, meeting facility, or public event space:

- **Childcare Center.** There is a strong desire to increase childcare facilities within the Middlefield Junction Master Plan area. The Redwood City Child Development Program (RCCDP) is a private, nonprofit child development and preschool program currently housed in about 8,000 square feet within the Fair Oaks Community Center. If relocated to Parcel A, this facility has expressed the desire to expand to about 12,000 square feet, with an additional 8,000-square foot playground. Alternatively, a similarly sized new childcare center also would be highly desirable given current demand for childcare in the neighborhood.

- **Other Non-Housing Use.** There is significant interest in having a wellness center that complements the nearby Fair Oaks Health Center. Such a facility would offer health and wellness programs for youth and families with young children. A wellness center might include a Woman, Infants, and Children (WIC) program, offerings for children and teenagers, senior programs, and a fitness center. A national evaluation of centers and programs suggests a facility of approximately 12,000 square feet. If a wellness center is infeasible, there also is interest in other public-serving, non-housing uses such as meeting and event facilities.

Before releasing the RFQ/RFP, the County seeks to better understand the feasibility of a mixed-use affordable housing development with childcare and other non-housing uses. Specifically, the County requested that EPS explore the potential for the project to take advantage of the federal New Markets Tax Credit (NMTC) program. This memorandum provides a summary of EPS's findings concerning the use of NMTC funding for childcare and wellness uses on Parcel A.

Key Findings

The site and uses qualify for the program. The Middlefield Junction Master Plan site qualifies as a highly distressed low-income community because its location is within census tracts that have median family incomes that are lower than 80 percent of Area Median Income (AMI), thus making the site eligible for the NMTC program. Further, the proposed commercial components of the planned mixed-use development likely will best achieve the requirements for NMTC funding if they are structured as a commercial condominium, to isolate the non-housing components of the development for NMTC financing.

Childcare and wellness uses likely are competitive for funding. The desired child care facility and wellness center uses align with the NMTC program mission since these programs will target low-income families and children. Interviewees noted that health and wellness centers, in particular, are very competitive for NMTCs, given the goal of many Community Development Entities to improve health in low-income communities.

The project likely is sufficient in scale for NMTCs to be an efficient funding source. Typically, projects awarded NMTCs have eligible costs between $5 million and $25 million. The transaction costs associated with NMTCs render their use impractical for smaller projects. At about 12,000 to 24,000 square feet, the costs to develop the proposed child care center, wellness facilities, and/or other non-housing uses likely will fall within the suitable cost range.

Successful implementation will require advanced planning and reliable additional sources of funding. Because project-readiness is an important criterion by which eligible projects are judged, developers must take care to coordinate the timing of NMTC awards with additional state, local, and/or federal funding sources. NMTCs typically finance approximately 20 percent of project costs, requiring developers to fund the remaining 80 percent from other sources.

Research Approach

EPS researched the guidelines and requirements of the NMTC Program by reviewing resources published by the US Department of the Treasury CDFI Fund, the Internal Revenue Service, and the New Market Tax Credit Coalition webpage. Upon reviewing the official parameters of the program, EPS interviewed several NMTC experts to gain a practical understanding of the challenges and rules of thumb regarding the use of NMTCs. The experts interviewed included representatives from Community Development Entities (CDEs) and consultants who help their clients obtain NMTCs from CDEs, as well as affordable housing developers. The facts and recommendations gained through this process are described below.

New Market Tax Credits and the Middlefield Junction Master Plan

The US Department of the Treasury established the New Markets Tax Credit program in 2000 with the goal of incentivizing and supporting economic development opportunities and real estate investment in low-income communities with a federal tax credit. As a non-permanent program in the Internal Revenue Code, the Program has been extended multiple times and is generally well-supported on both ends of the political spectrum. Funding from the NMTC program is limited to low-income communities as defined by the Treasury's Community Development Financial Institutions Fund.[1] Each year, NMTCs are awarded to Community Development Entities (CDEs) through a competitive application process. CDEs provide loans, investments, and support to entities that work in low-income communities. The CDEs, at their discretion, distribute the federal tax credits to investors who provide equity investment in Qualified Active Low-income Community Businesses (QALICB).[2]

As of 2017, the Middlefield Junction Master Plan site qualifies as a highly distressed low-income community because its location is within census tracts that have median family incomes that fall below 80 percent of Area Median Income (AMI), thus making the site eligible for the NMTC program. The proposed child care and wellness center uses also align with the NMTC Program's mission, since the child care and wellness programs envisioned are likely to target low-income families and children. In particular, interviewees noted that health and wellness centers are very competitive for NMTCs, given the current desire of CDEs to focus on improving health in low-income communities.

NMTC Program Requirements

Funding from the NMTC Program is not available for all uses. Credits may not be used for the development of 100 percent residential developments. However, they can be used to develop

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[1] In general, a low-income community has a poverty rate at or above 20 percent, or the median family income is less than 80 percent of AMI.

[2] A QALICB is a business entity that serves a low-income population and conducts acceptable business activities as outlined by the NMTC program.

mixed-use projects that include housing. Should a developer use NMTCs for a mixed-use project that includes residential and a QALICB, then at least 20 percent of the project's gross rental income must be generated by the QALICB portion of the project. Because most child care, wellness and other public-oriented uses are unlikely to be capable of paying significant rent, it is unlikely that the project will qualify for NMTCs as a mixed-use development. However, experts interviewed recommend that the project can be bifurcated to separate the housing from the non-housing components. By establishing a commercial condominium structure for the childcare, wellness and other non-housing uses, these uses alone may be positioned to be eligible for the NMTC program.

New Market Tax Credit Thresholds

Speaking with NMTC experts revealed that the NMTC Program is best suited for projects with eligible costs of at least $5 million. Typically, projects awarded credits have eligible costs between $5 million and $25 million. The transaction costs associated with NMTCs render their use impractical for smaller projects. Larger projects commonly require credit allocations from multiple CDEs, since a single CDE commonly can distribute $8 million to $15 million to each QALICB. Experts note that a significant amount of time and effort is required to coordinate multiple CDEs. At 24,000 square feet, the cost to develop the child care center, wellness facilities, and/or other non-housing uses would likely fall within the cost range that is suitable for NMTCs. Also, it is notable that land cost can be eligible for NMTC funding as long as it is an actual project cost incurred (e.g., a fee simple sale or an upfront ground lease payment).

New Market Tax Credit Financing

Developers may use NMTCs to finance up to 39 percent of capital costs. However, given investor discounting of the credits (which occurs over seven years) and transaction costs, the credits end up funding roughly 20 to 25 percent of total project cost. Currently, investors value NMTCs at about $0.87 cents on the dollar. Assuming 20 percent of costs are financed by NMTC, project developers still need to fund the remaining 80 percent of the project. Typical sources for the other 80 percent include developer equity, fundraising dollars, grants, bridge loans for future fundraising, and traditional loans. Typically, projects rely on a single "leveraged lender" that bundles the funding sources for the other 80 percent of project cost.

While developers can use local, state, and federal funds in addition to NMTCs, it can be difficult to align the timing of multiple funding sources. Program experts indicated that local sources of funding likely would be most desirable, since their availability and timing commonly is more certain than state and federal sources. Interviewees also recommended that the Project developer must be careful to coordinate any Low-Income Housing Tax Credits (LIHTC) with the timing of NMTCs, so that they are awarded in the same year. To achieve this, the project proponent likely should seek one investor for both LIHTCs and NMTCs. Also, because nine percent LIHTCs have a more stringent timeline than four percent LIHTCs and are highly competitive, it can be difficult to coordinate the timing of NMTCs with nine percent LIHTCs.

The process for applying for NMTCs is similar to the application process for LIHTCs. EPS spoke with several affordable housing developers who were not very familiar with the NMTC Program, but their expertise with LIHTCs is likely to be advantageous when undertaking the NMTC process. Some interviewees recommended that the developer should retain a NMTC expert to help them secure the funding. In fact, some CDEs prefer applicants to have a NMTC consultant on board. In addition to coordinating several funding sources, it is particularly important that developers be strategic with the timing of development activities and funding source coordination.

How to Apply for New Market Tax Credits

In terms of actually obtaining NMTCs, those who wish to use NMTCs to develop QALICB facilities must first attract a CDE with the potential to award NMTC. The NMTC program does not have a standard benchmark by which each QALICB is judged. Instead, CDEs choose to support QALICBs based on their individual mission and funding goals. For example, some CDEs focus on supporting child services, others have a health-oriented mission, and still others might focus on small businesses and entrepreneurs. Commonly, applicants start by building relationships with local CDEs and national CDEs whose mission statements align with their project. Once an applicant builds good rapport with a CDE, that CDE often includes the applicant's proposed project in their application for a NMTC allocation. To be successful, CDEs often focus on identifying projects that are ready to build (e.g., entitlements, contractors, outside financing, etc. are lined up) so that construction can begin soon after funding is awarded. In order to receive future NMTC allocations, CDEs seek to demonstrate efficient execution of successful projects.

A project developer may be included on multiple CDEs applications for NMTCs, and in fact, should develop relationships with up to 10 CDEs to increase their chances of being awarded funding. Being included on a CDE's application does not guarantee the award of NMTCs, but it is a good indicator. While the process generally follows a similar annual cycle, the program does not have due dates that are consistent year to year, so applicants need to be cognizant of unique deadlines and plan accordingly. In 2017, CDE application materials had to be submitted by the end of June, and it is anticipated that the 2017 NMTC awards will be announced in late 2017 or early 2018.

Program Uncertainties

While the non-housing uses desired at Middlefield Junction are a good fit for the use of NMTCs now, the location's income qualification status could change as local demographics evolve. For example, though the Master Plan's census tracts currently qualify the sites as being within highly distressed low-income communities, and thus eligible for the NMTC program, the median family income relationship with Area Median Income could change according to future US census data.[3] In addition, it is notable that the NMTC program technically ends in 2019 and would require renewal by Congress to continue. It is unclear whether the current administration intends to continue the program, so it is important to consider that use of NMTC at Middlefield Junction is contingent on the project being renewed in 2019.

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- Andrea Papanastassiou, Northern California Community Loan Fund - CDE
- Chris Neale, Core Companies – Affordable Housing Developer
- Jamie Hiteshew, Bridge Housing – Affordable Housing Developer

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[3] The eligibility criteria for low income communities has been based on a combination of the decennial Census data and the shorter term 2006-2010 Census American Community Survey (ACS) data.

- John Clawson and Suzanne Brown, Equity Community Builders – Developer with NMTC expertise
- Nevada Merriman, MidPen Housing – Affordable Housing Developer