NORTH CAROLINA

- ✓ Tax-linked bonuses
- ✓ Housing trust funds

A number of states, including Minnesota, Oregon, California, North Carolina, Missouri, and New Jersey, offer state tax credits for affordable housing. Of these, North Carolina's goes the farthest in the amount of affordable housing per state dollar of tax expenditure.

A typical state tax credit is very similar to the federal Low Income Housing Tax Credit. Developers of affordable housing receive an allocation of tax credits, which are sold through a syndicator to investors who want to reduce their tax liability. The money raised through the sale of the tax credits is used as the developers' equity in the project. Inefficiency arises through the administrative costs of selling the tax credits, the impact of changes in state tax liability on federal taxes, and in the level of demand for state tax credits.

Although federal tax credits sell to investors for almost $1 for each $1 of the government's foregone tax revenue, these typical state tax credits sell for much less. In addition to limited demand for the credits, the price of state tax credits reflects the fact that they increase federal fax liability. State taxes reduce federally taxed income, so reducing state tax liability increases federal tax liability, typically by 35 percent for corporations. As a result, $1 in foregone state revenue results in $.65 in affordable housing investment at best, and in some states much less.[98]

North Carolina's tax credit (called a tax-linked bonus) is structured in a way that avoids these inefficiencies. Similar to the federal Earned Income Tax Credit, the program provides a subsidy through a refundable tax credit that returns funds to taxpayers, even if they do not have any tax liability. The owner of a tax-credit project, either a limited liability company or a limited partnership, claims the credit. Since these pass-through entities inherently have no income tax liability, the full amount of the credit is refunded. Owners transfer the right to this refund to the North Carolina Housing Finance Agency (NCHFA), which then makes a loan to the project in the same amount.[99]

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North Carolina's state tax credits can only be used for projects that are allocated federal Low Income Housing Tax Credits. Almost all LIHTC projects (over 90 percent) also use the state tax credit, which is set at 10, 20, or 30 percent of the development's eligible basis, depending on whether it is in a high-, moderate, or low-income county. On average, state tax credits contribute about $16,000 per affordable unit.

Because state tax credits must be used with the federal LIHTC, the amount of state tax credits in any year is limited by the state's federal tax credit ceiling. As a tax credit, however, it is not subject to the state's annual appropriation process.

According to Mark Shelburne, NCHFA's counsel and policy coordinator, the state tax credit is very well distributed across high-, medium-, and low-income areas of the state. In addition to the LIHTC, the state tax credit is also often used in combination with federal HOME funds or money from the state's housing trust fund.

Shelburne says legislative approval of North Carolina's tax-linked bonus in 2002 was the result of an unusual alignment of political will in favor of affordable housing. He said the affordable housing community "Had the 'perfect storm' of an alignment of forces in our favor."

Like other states, North Carolina's affordable housing tax credit was initially also very similar to the federal LIHTC. The original state tax credit, implemented in 1999, was initially successful, but the pool of investors was extremely limited—they had to have both significant state tax liability and familiarity with affordable housing and tax shelter investing.[100] After two years, these institutions had reached the limit of their need to offset state taxes, and according to Shelburne, the value of the state tax credits would have been reduced to zero. As a result, most LIHTC projects in the works, which also relied on the state tax credit, would have unexpected large financing gaps, making them financially infeasible, and future projects would have more debt and higher rents.

Shelburne says this funding crisis was one critical component of getting a more efficient affordable housing funding mechanism. The second was determination and a close working relationship between the NCHFA, the Department of Revenue, and key legislators, and the third was a good argument.

"We were able to show how to save money and increase the subsidy [to affordable housing projects]," said Shelburne. The relationships were equally important: "Just having a compelling case isn't enough to make something happen legislatively," cautions Shelburne.

According to Shelburne, the tax-linked bonus does three things. First, it allows properties to be funded in rural areas, which was one of the initial goals of the tax credit. "Otherwise, it's hard to make federal tax credit projects work – [rural areas] have such low rents," said Shelburne.

Second, in urban areas, the tax credit allows deeper subsidies than would otherwise be possible. Because of the state tax credit, about one-quarter of units in high-income counties are affordable to households with incomes of 30 percent of the area median income.

Third, the tax credit allows 10 percent of units to be set aside for people with disabilities, who often have extremely low incomes. These units are given an operating subsidy by the state through the Key Program, which makes up the difference between what disabled residents can afford and the operating costs of the unit. In addition, owners partner with local human services agencies to provide placement, supportive, and other services to disabled tenants.[101]

In all of these situations the result is housing that is more affordable for low-income renters.

Although a number of other states have investigated North Carolina's tax-linked bonus, none has adopted it. One reason is that states with an existing affordable housing tax credit risk the possibility that their state legislature might eliminate the credit altogether rather than passing the legislation necessary to switch to a tax-linked bonus. North Carolina had an existing affordable housing tax credit before converting to a tax-linked bonus, but was fortunate during the legislative approval process that essential stakeholders did not advocate for its elimination. Importantly, the state's Department of Revenue was convinced that the tax credit was valuable, and supported the switch to the tax-linked bonus.

> ***"We might not have made the change if we were not backed into a corner."***
>
> -Mark Shelburne

Still, "We might not have made the change if we were not backed into a corner," said Shelburne. "We wouldn't have done it but we had nothing to lose. Other states still have something to lose, even if it's $.20 on the dollar."

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