OVERVIEW OF EMPOWERMENT ZONE TAX INCENTIVES

Tax Credits

- Reduces federal tax liability of business – if a business owes $50,000 in federal taxes and has 17 employees that qualify for the full $3,000 EZ employment credit, the business would owe no taxes and would have $1,000 credit to carry forward or back.
- Credits are "nonrefundable" – if a business does not owe any federal taxes in the year the credit is earned, the business does not get a refund of the credit amount.
- Unused credits (credits exceeding tax liability) can be carried forward 20 years (and back 3 years, generally)

Expensing

- General tax rule that expense of asset with economic life greater than 1 year is spread out over life of asset
- Taxpayer would rather reduce income in the year the asset was purchased
- Expensing or accelerated depreciation reduces taxable income, which ultimately reduces federal tax liability
- If expenses greater than income in a taxable year, various ways of carrying over losses depending on activity and status of taxpayer
- Benefit of expensing depends on marginal tax rate and other specific tax attributes of taxpayer

Bond Financing

- Tax benefit is taken by the holder of the tax-exempt bond who does not pay income tax on interest income it receives
- Financial benefit to business borrower of lower interest cost
- Public/private partnership in that bonds must be issued by state or local government

Capital Gains

- Income and losses related to the sale of capital assets
- Capital losses netted against capital gains, so timing of gain and loss can be important.
- Incentives relate to tax on appreciation in property only so if not expected to be worth more, incentive not important

- Minimum holding periods to take advantage of incentive may tie up investments

EMPOWERMENT ZONE EMPLOYMENT TAX CREDIT

Eligible Business

- Any business with qualified employee who performs services in the EZ
- Credit available for portion of time the employee performs services in the EZ
- Example: Construction worker performs services in EZ for part of year – take credit based on pay period or portion of year

Qualified Employees

- Any employee who resides in the EZ
- Credit for new-hires and existing employees
- Credit for full-time or part-time after employed minimum of 90 days
- Does not include: 5% owner, relatives of employer, employees of certain businesses (gambling establishments, golf course, country club, liquor store, massage parlor, suntan facility, certain farms)

Credit Calculation

- Percentage of wages paid or incurred for any calendar year = 20%
- Qualifying wages limit per calendar year = $15,000
- Use FUTA definition of wages
- Credit available through December 31, 2009

WORK OPPORTUNITY TAX CREDIT
WELFARE TO WORK TAX CREDIT

Qualifying Employees.

- EZ youth category. Youth at least 18 years old and not older than 24 years (on the hiring date) who resides in a EZ.
- EZ youth category. Youth at least 16 years old but not 18 on the hiring date who resides in EZ and who performs services for the employer in the summer (between May 1 and September 15).
- Must be new hire

- Expires for employees who begin work after December 31, 2003.

Credit Amount.

- The chart shows the credit amount, which is based on the number of hours the new hire works for the employer.

Hours Worked	Rate	Maximum Qualified Wages	Maximum Credit
At least 400	40%	$6,000*	$2,400
Fewer than 400 at least 120	25%	$6,000*	$1,500

*$3,000 for a summer youth employee

- Enhanced credit for long-term welfare recipient (regardless of where employee resides)

Years Worked	Rate	Maximum Qualified Wages	Maximum Credit
1st Year	35%	$10,000	$3,500
2nd Year	50%	$10,000	$5,000

Credit Procedures.

  - The employer must get a certification from the state employment security agency (SESA) that the new hire is a member of a "targeted group." To receive certification, the employer must either:
  - Receive the certification by the day the individual begins work, or
- Do both of the following:
  - Complete IRS Form 8850 by the day individual is offered a job, and
  - Submit the form to the SES
- Youth may be "pre-certified" to shorten process

ENTERPRISE ZONE BUSINESS DEFINITION

Business Operational Requirements

Any corporation, partnership or sole proprietorship that meets the following requirements for the taxable year

- every trade or business is the active conduct of a qualified business within the EZ

- at least 50% of business income is derived from the active conduct of a trade or business within the EZ

- a substantial portion of the use of the tangible property (owned or leased) of the business is within the EZ

- a substantial portion of the intangible property of the business is used in the active conduct of business in the EZ

- a substantial portion of services performed for the business by its employees is performed in the EZ

- at least 35% of the employees are residents of the EZ

- less than 5% of the average of aggregate adjusted bases of the property of the business is attributable to collectibles (art work, wine, antiques) other than collectibles held primarily for sale to customers in the ordinary course of business

- less than 5% of the average of the aggregate adjusted bases of the property of the business is attributable to "nonqualified financial property" (debt, stock, partnership interests, options, futures contracts) other than reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of no more than 18 months)

Definition of "Qualified Business"

Any trade or business other than:

- business predominately involved in the development or holding of intangibles for sale or license (such as software)

- rental of commercial real estate unless at least 50% of gross rental income is from EZ businesses

- the rental of residential real estate

- the rental of tangible personal property unless at least 50% of rentals are to EZ businesses or EZ residents

- country clubs

- massage parlors

- hot tubs

- racetracks

- health clubs

- stores the principal business of which is the sale of alcoholic beverages for consumption off premises

- Farming unless the aggregate unadjusted bases of the assets owned or leased by the taxpayer which are used in the trade or business of farming are less than $500,000 as of the close of the taxable year

TAX INCENTIVES REQUIRING EZ BUSINESS

- Increased Section 179 Expensing

- Tax–exempt Bonds

- Nonrecognition of Gain on Sale of Empowerment Zone Assets

- Partial Exclusion of Gain on Sale of Empowerment Zone Stock

EXPENSING

- Section 179 of Internal Revenue Code allows election to deduct cost of personal property in the year the property is placed in service, up to specified limit

- Expensing limit is increased by up to $35,000 for Qualified Zone Property (QZP) after December 31, 2001

- Expensing Allowance/QZP Allowance

For Tax Years Beginning In:	Maximum Section 179 Dollar Limit	Maximum Dollar Limit With Qualified Zone Property
2002	24,000	59,000
2003 or thereafter	25,000	60,000

- Investment Limit - each dollar over $200,000 reduces expensing by $1
    - Each dollar over $200,000 for QZP/QRP reduces expensing by $0.50

- Recapture
    - If a business fails to meet the EZ business definition or if the property is no longer used in the Zone.

- EXAMPLE

  Two businesses, A meets the definition of EZ, Business B does not.

  Year 1 - Both buy $60,000 in equipment

Year 2 - Both buy $300,000 in equipment

	A Year 1	B Year 1	A Year 2	B Year 2
QZP	$60,000	$ 0	$300,000	$ 0
Non QZP	0	60,000	0	300,000
TOTAL	$60,000	$60,000	$300,000	$300,000
Expensible	$59,000	$24,000	$ 59,000	$ 0
Depreciable	1,000	36,000	241,000	300,000
TOTAL	$60,000	$60,000	$300,000	$300,000

QUALIFIED ZONE PROPERTY

Tangible personal property of a taxpayer where all of the following are true:

1) The taxpayer acquired the property after the EZ designation is in effect.

2) The taxpayer was the first person to use the property in the EZ or property is substantially renovated (100% of basis or $5,000 if greater) with 24-month period.

3) At least 85% of the property's use is in the EZ and in the active conduct of a qualified trade or business of an EZ business.

4) The taxpayer did not acquire the property from a related person or member of a controlled group of which the taxpayer is a member.

ENVIRONMENTAL CLEANUP COST DEDUCTION

Deduction preferable to depreciation. The business can elect to deduct "qualified environmental cleanup costs" that are contaminated with hazardous substances in the tax year the business pays or incurs the cost. The business does not have to be an EZ business to qualify for this deduction.

- Time limitation. This special tax treatment is generally available for qualified environmental cleanup costs paid or incurred after August 5, 1997, and before January 1, 2004.

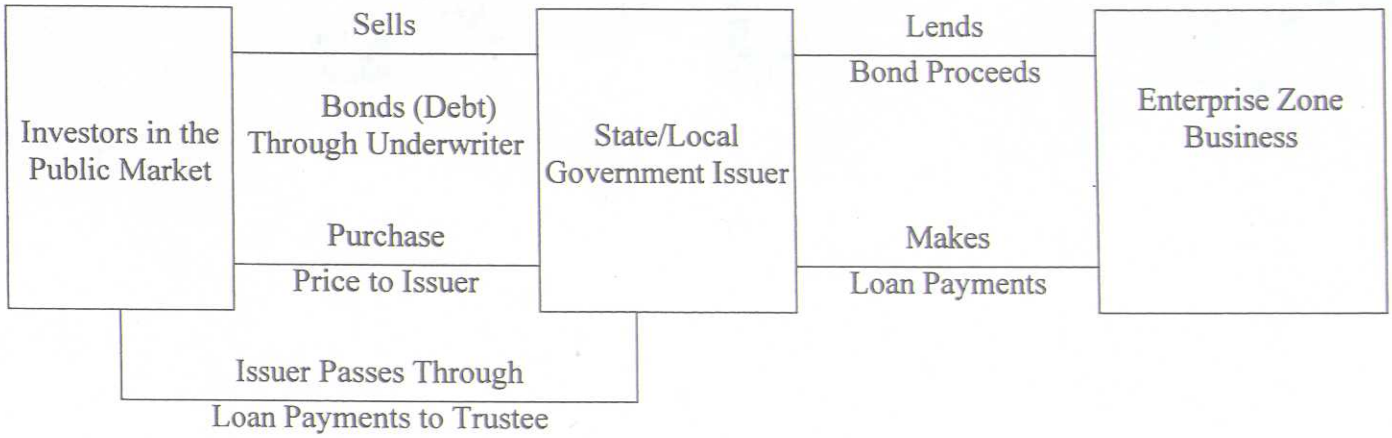
Recapture. The deduction may have to be recaptured as ordinary income under §1254 of the Code when it is sold or otherwise disposed of.

- Qualified environmental cleanup costs. Qualified environmental cleanup costs are generally costs paid or incurred to abate or control a hazardous substance (as defined by Internal Revenue Code section 198(d)) at a "qualified contaminated site."

- Qualified contaminated site. A qualified contaminated site must meet all of the following requirements.
    - The business holds it for use in a trade or business, for the production of income, or as inventory.
    - There has been a release or threat of release of a hazardous substance at or on the site.

<u>The business must get a statement from the designated state environmental agency that the site meets requirements.</u>

A TAX-EXEMPT BOND TRANSACTION



Technical Steps, Documents, Players

- Private business meeting definition of Enterprise Zone Business makes application to State or Local Government Issuer
- Issuer reviews and approves financing after a published notice and public hearing
- Issuer enters into bond purchase agreement with underwriter or placement agent (investment banking firm)
- Underwriter, EZ business and issuer prepare securities offering document for the bonds, describing the terms of the bonds, the project to be financed, the security for repayment of the bonds
- Legal counsel specializing in federal tax laws related to municipal bonds review transaction and deliver opinion to purchasers of bonds that interest income the bond purchaser receives will be exempt from federal income tax (and usually also from state and local income taxes of the Issuer's state)
- Investor is willing to charge a lower interest rate for the Issuer's debt because the interest income is exempt (investor gets higher return)
- Underwriter sells the Issuer's bonds in the public debt market based on the credit of the EZ business (or a letter of credit bank)
- Issuer enters into a loan agreement with the EZ business to lend the money from the sale of the bonds to the EZ business
- Issuer passes on lower rate to EZ business on the Issuer's loan, but Issuer may charge the EZ business an up-front or continuing fee for its debt program

- Loan Agreement will have financial and tax covenants the EZ company must comply with throughout the term of the bonds. Financial covenants will be based on what the Underwriter believes are necessary to sell the Issuer's bonds to the public

- Issuer enters into Trust Indenture with a trustee bank to carry out the Issuer's obligations to the investors

- EZ business requisitions money from Trustee to pay costs of the project

- EZ business makes loan payments to the Trustee, who passes the payments on to bondholders

TIME PERIOD FOR MEETING ENTERPRISE ZONE BUSINESS DEFINITION

Start-Up Period

- Borrowers are allowed up to 2 years after the later of the date the bonds are issued or the date the financed property is placed in service to come into compliance with enterprise zone business requirements.

- To qualify for the start-up period, the borrower must expect to meet the tests by the end of the start-up period.

Test Period

- The requirements for being an enterprise zone business (other than the resident employee requirement) must be met only for the first three taxable years beginning after the start-up period

- In addition, throughout the zone designation period or average term of the bonds, if less, the following requirements must be met:

- The business must be a "qualified business"

- At least 35% of the employees of the business are residents of the Zone

For tax-exempt financing purposes only, a business may meet the business definition by treating its business operations in the EZ as separately incorporated (for example, the EZ store of a national chain could apply the tests to the EZ operations only).

What Can Be Financed

- acquiring land (limited to an amount related to the needs of the business)

- constructing a new facility

- acquiring an existing building if the building is renovated in an amount equal to 15% of building purchase price
- rehabilitating an existing facility
- expanding an existing facility
- acquiring new equipment
- acquiring used equipment that has not previously been used in the EZ
- acquiring a building abandoned prior to EZ designation

Limit on the Principal Amount of Bonds Issued During Zone Designation Period

• Rural Zones	$60 million
• Urban Zones (Zone population 100,000 or less)	$130 million
• Urban Zone (Zone population greater than 100,000)	$230 million

- No limit per borrower in EZ: $3 million per borrower limit in EC and subject to state private activity bond volume cap

NONRECOGNITION OF GAIN ON SALE OF EMPOWERMENT ZONE ASSETS

Postpone gain on selling empowerment Zone assets (EZA by rolling over gain to replacement EZA

Eligible Assets

- Stock in EZ business corporation acquired by taxpayer at original issuance from the corporation solely in exchange for cash after December 21, 2000 and before January 1, 2010
- Capital or profits interest in EZ business partnership acquired by taxpayer at original issuance from partnership solely in exchange for cash after December 21, 2000 and before January 1, 2010
- Tangible property used by EZ business purchased after December 21, 2000 and before January 1, 2010
- If real property or intangible asset, must be integral part of EZ business

Holding Period

- Asset must be held for at least 1 year
- Business must remain EZ business for holding period

Amount Rolled Over

- Amount realized from sale to the extent it does not exceed the cost of a replacement Empowerment Zone Asset
- Replacement asset must be purchased within 60 days
- Example: Taxpayer buys stock in EZ business for $100 and sells stock 2 years later for $150 for a gain of $50. Taxpayer buys new stock in another EZ business for $60 within 60 days. Taxpayer does not have to pay capital gain on $50 of gain.
- Gain on replacement asset can also be rolled over if otherwise meets requirement and is held for at least one year.

PARTIAL EXCLUSION OF GAIN ON SALE OF EMPOWERMENT ZONE STOCK

Qualified Stock

- Must be stock in a small business corporation with gross assets of $50 million or less (gross assets = cash and property over indebtedness)
- Stock must be purchased upon original issuance by corporation after December 21, 2000
- Corporation must meet requirements of EZ business when stock purchased or be formed for purpose of meeting requirements

Holding Period

- Must hold stock for at least 5 years
- Corporation must be EZ business for substantially all of the holding period

Amount of Gain Excluded

- Exclude 60% of gain on sale or exchange of stock
- Overall limit on excluded gain of 10 times the basis in the stock or $10 million gain from stock in that corporation
- Gain after December 31, 2014 not eligible for partial exclusion

NEW MARKETS TAX CREDIT

Credit Procedures and Calculation

- U.S. Treasury Department will allocate credits to qualified community development entities (CDEs) equal to $2.5 billion for 2002, $1.5 billion in 2003, $2 billion each year for 2004 - 2005 and $3.5 billion each year for 2006 - 2007. The CDE will have up to five years to allocate the credit to specific investments.

- Equity investors in a CDE that has received an allocation will be permitted to take a credit against Federal taxes of 5%-6% of the amount invested for each of the years the investment is held, for up to 7 years of the credit period. The first credit amount is available when the investor makes an equity contribution to the qualified CDE.

- Credit is available only in cases where the stock of a corporation, a membership interest of a limited liability company, or capital interest in a partnership is acquired at original issuance for cash. An investment acquired through an underwriter at original issuance would meet this requirement.

- NMTC is a general business tax credit, and can be carried forward 20 years and carried back one year (except for tax years ending prior to January 1, 2001).

- Credit is available to subsequent purchasers of the investment, so if an initial investor is unable to use the tax credit, the investment can be transferred.

- Credit is subject to recapture during the seven-year credit period if the entity invested in ceases to be a CDE, the proceeds of the investment are not used to make Qualified Investments or the investment in the CDE is redeemed by the CDE. The recapture amount is generally based on tax benefit derived from the credit.

- Taxpayer's basis in the investment is generally reduced by the amount of the credit.

- Credit is subject to the general business credit and passive loss limitation rules and cannot be used to reduce the AMT liability of an individual or corporation.

Qualified CDE

- A CDE is any domestic corporation or partnership for Federal tax purposes (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons, (2) that maintains accountability to residents of low-income communities by their representation on any governing board or on any advisory board of the CDE, and (3) is certified by the Treasury Department as an eligible CDE.

- In allocating the credits, the Treasury Department will give priority to entities with records of having successfully provided capital or technical assistance to disadvantaged businesses or communities, as well as to entities that intend to invest substantially all of the proceeds from their investors in businesses in which persons unrelated to the CDE hold the majority of the equity interest.

- A "small business investment company" (as defined in the tax laws) and a "community development financial institution" (as defined in Federal banking laws) are treated as meeting these requirements.

- Entity applies to the Treasury Department to be certified as a CDE. The Treasury Department will publish a list of the CDEs designated each year.

<u>Required Uses of Equity Investments in CDE</u>

- The CDE must use at least 85% of the cash infusion to make a "qualified low-income community investment" (a Qualified Investment). A Qualified Investment is includes:

    - a capital or equity investment in, or loan to, a "qualified active low-income community business" or a qualified CDE,

    - the purchase of a loan made by another qualified CDE to a qualified active low-income community business, or

    - the provision of financial counseling and other similar services to businesses and residents located in low-income communities.

- No limits on the use of the remaining 15% of the equity raised by the CDE.

- Reasonable reserves (5%) are treated as being part of the 85% good uses of equity investments.

<u>Qualified active low-income community business" (Qualified Active Business)</u>

- A "qualified active low-income community business" is defined as a corporation, partnership or sole proprietorship that meets the following tests:

    - at least 50% of its gross income comes from the active conduct a qualified business within any low-income community.

    - a "substantial portion" of the use of tangible property of the business (whether owned or leased) must be within any low-income community,

    - a substantial portion of services of employees must be performed in any low-income community.

    - no more than 5% of the property of the business can be "nonqualified financial property," defined as debt, stock, partnership interests and various financial instruments generally (other than reasonable amounts of working capital held in cash or short-term debt instruments or accounts receivable arising from sales of inventory).

    - No more than 5% of the property of the business can be works of art or other "collectibles," unless held for sale to customers.

- Definition is a modification of the definition of Enterprise Zone Business, with no requirement that a specified percentage of employees live in the low-income community.

- Certain businesses cannot qualify, including residential rental property; a business, the predominant activity of which is the development or holding of intangibles for sale or license; a golf course, country club, massage parlor, hot tub facility, suntan facility, race track or other facility used for gambling; or a store, the principal business of which is selling alcoholic beverages for consumption off-premises.

- Rental of improved commercial real estate located in a low-income community is a Qualified Active Business, regardless of the characteristics of the commercial tenants of the property. The purchase of and holding of unimproved real estate is not a Qualified Active Business.

- A Qualified Active Business can include an organization that is organized on a non-profit basis.

<u>Low-income Community Definition</u>

- A "low-income community" is defined as census tracts with either (1) poverty rates of at least 20 percent (based on the most recent census data), or (2) a median family income which does not exceed 80 percent of the greater of metropolitan area income or statewide median family income (for a non-metropolitan census tract, 80 percent of non-metropolitan statewide median family income).

- Treasury Department may designate any area within any census tract as a "low income community" provided that (1) the boundary of the area is continuous, (2) the area (if it were a census tract) would satisfy the poverty rate or median income requirements within the targeted area, and (3) an inadequate access to investment capital exists in the area.