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## Aiming the Tax Code at Distressed Areas: An Examination and Analysis of Current Enterprise Zone Proposals

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AIMING THE TAX CODE AT DISTRESSED AREAS:  
AN EXAMINATION AND ANALYSIS OF CURRENT  
ENTERPRISE ZONE PROPOSALS

*Scott A. Tschirgi\**

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Standing on top of the Sears Tower in the business district of downtown Chicago, an observer can see the Henry Horner Homes so clearly that the individual residents of this housing project are distinguishable.<sup>1</sup> The observer also can see the deserted buildings in the Twenty-Seventh Ward, the Ward where the Henry Horner Homes housing project is located.<sup>2</sup> Of the 60,110 people who live in the Twenty-Seventh Ward, 88% are Black.<sup>3</sup> Forty-six percent of the residents live below the poverty level.<sup>4</sup> Over the past two decades, residents of Henry Horner Homes have watched their neighborhood decay.<sup>5</sup> Initially the middle class whites, then the middle class blacks, moved to the suburbs in search of safer neighborhoods.<sup>6</sup> Next, the businesses moved out; some went to the suburbs, and some went to other parts of the nation.<sup>7</sup> The unemployment is officially at 19%; unofficially, it is likely higher.<sup>8</sup> In 1982, Mother Teresa visited the Henry Horner Homes and found the area so impoverished that she assigned nuns to set up shelters and provide soup kitchens for its residents.<sup>9</sup>

There is increasing debate on how the federal government can help the many citizens of this nation's inner cities who live in conditions resembling those of Henry Horner Homes. These citizens suffer from chronic poverty and unemployment. Indeed, they seem trapped in a

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1. ALEX KOTLOWITZ, *THERE ARE NO CHILDREN HERE* 12-13 (1991). Kotlowitz's book is a true account of a family living in the Henry Horner Homes project, and provides this description of the project.

2. *Id.* at 13.

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

cycle of poverty. Lacking education, skills, or job training to find employment, they lack the opportunity to break the poverty cycle, either for themselves or for their children.

Thus far, the federal government has attempted to deal with poverty and unemployment by providing direct subsidies. But these programs have failed and the poverty cycle has not been broken, particularly in the inner cities. Recognizing this failure, Congress is considering proposals to spur economic activity in identifiably distressed areas through amendments to the Internal Revenue Code (I.R.C.). If adopted the amendments would create "enterprise zones," residents and businesses located in the enterprise zones would be eligible for preferential tax treatment. Enterprise zones are an effort to bring economic development, employment, and a better quality of life to citizens of our inner cities.<sup>10</sup>

## I. INTRODUCTION

A British socialist, Peter Hall, addressed the British Royal Town Planning Institute in the late 1970s.<sup>11</sup> Hall perceived an emigration of business out of the inner cities of England, areas which historically were centers of industry, into suburban or smaller city locations.<sup>12</sup> This exodus from the inner cities by business left decay, poverty, and unemployment.<sup>13</sup> In his address, Hall proposed a solution to counter the decline in the inner cities; his solution was to create a "freeport."<sup>14</sup> To spur economic recovery, selected areas of the inner cities would be thrown open to all kinds of incentives.<sup>15</sup> The primary motivation would be tax cuts; other incentives included reduced social services and less regulations.<sup>16</sup> Hall's idea was to "recreate the Hong Kong of the 1950's and 1960's inside inner Liverpool or inner Glasgow."<sup>17</sup> Hall's conception was labeled "enterprise zones."<sup>18</sup> In its simplest form, the idea was to designate selected areas of poverty and unemployment as

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10. Peter Hall, *Enterprise Zones: A Justification*, 6 INT'L J. URB. & REGIONAL RES. 416, 417 (1982). Current enterprise zone legislation is not limited to inner cities. Rural areas are also included in the legislation. See, e.g., H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(b)(2)). However, this article chooses to focus primarily on the inner cities.

11. Hall, *supra* note 10, at 416.

12. *Id.*

13. *Id.* at 417.

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. See *id.*

enterprise zones. Once designated, the area receives special tax incentives and investment incentives in an attempt to spur economic development and growth. In turn, this new economic activity creates jobs and opportunities.

In 1980, Jack Kemp, (then a New York Congressman, now Secretary of Housing and Urban Development (HUD)) introduced the first enterprise zone legislation.<sup>19</sup> The topic has been introduced in every succeeding session. President Bush called for enterprise zones in his 1991 State of the Union Address.<sup>20</sup> In the 1991 session, Congress again debated enterprise zone legislation. House Bill 11 (Enterprise Zone Tax Incentives Act of 1991) was introduced by Chairman Rostenkowski of the House Ways and Means Committee.<sup>21</sup> House Bill 23 (Enterprise Zone Jobs — Creation Act of 1991), the Bush administration's proposal for enterprise zones, was introduced by Representative Charles Rangel of New York, on behalf of HUD Secretary Jack Kemp.<sup>22</sup> An identical version of House Bill 23 has been introduced in the Senate, Senate Bill 1032, by Senators Danforth and Lieberman.<sup>23</sup>

The purpose of this article is to examine and compare the relative provisions and merits of the current proposals before Congress, and to reflect upon factors outside of the legislation which may or may not determine the ultimate effectiveness of enterprise zones. The article first examines how under each bill an enterprise zone is designated, and the problems that may be encountered in the selection process. Next, the article examines the heart of the enterprise zone theory — tax and investment incentives. Both House Bills use tax credits and capital gain deferral or exemption from tax to stimulate growth in enterprise zones. The article examines the potential ability of these incentives to create economic activity in the zones. The article then recommends improvements to the incentives. Finally, the article discusses the potential impact of enterprise zones and whether they will help solve the problems of distressed areas. For reference, the appendix contains a side-by-side comparison between House Bill 11 and House Bill 23 of the designation process and of the tax and investment incentives.

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19. See H.R. 7563, 96th Cong., 2d Sess. (1980).

20. President George Bush, 1991 State of the Union Address (Jan. 29, 1991), *reprinted in* 1991 U.S.C.C.A.N. D3, D6. "The budget also includes a plan of action right here at home to put more power and opportunity in the hands of the individual. That means new incentives to create jobs in our inner cities, by encouraging investment throughout enterprise zones." *Id.*

21. See H.R. 11, 102d Cong., 1st Sess. (1991).

22. See H.R. 23, 102d Cong., 1st Sess. (1991).

23. See S. 1032, 102d Cong., 1st Sess. (1991).

## II. DESIGNATION OF ENTERPRISE ZONES

Generally, the first step in the designation process under both House Bill 11 and House Bill 23 is to have the state and local governments nominate an area as an enterprise zone.<sup>24</sup> Once nominated, the Secretary of HUD determines whether the area will be designated as an enterprise zone.<sup>25</sup> Several criteria must be met for the Secretary to consider the area. The criteria include poverty and unemployment rates exceeding the national rates, and a proposed course of action by state and local governments to assist in the revitalization program.<sup>26</sup> Designation thus is a competitive process; the areas are selected based upon eligibility requirements.<sup>27</sup> Those state and local governments which propose the optimum assistance to the area and which properly establish the requisite poverty and unemployment rates in the targeted area increase their chance of obtaining enterprise zone designation.<sup>28</sup>

### A. Designation Under House Bill 11

Under House Bill 11, the designation process begins when the state and local governments nominate an area as a tax enterprise zone.<sup>29</sup> The process is completed if the Secretary of HUD designates the area as an enterprise zone.<sup>30</sup> Several areas may be eligible, but the Secretary can select only twenty-five areas to receive the HUD designation.<sup>31</sup> The twenty-five designations will be made in the years 1992 through 1995.<sup>32</sup> A designation remains in effect for twenty-five years.<sup>33</sup> The area's designation can be revoked by the Secretary of HUD upon a finding that the local government has either significantly

24. H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(a)(1)(A)); H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1391(a)(1)).

25. H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(c)(3)); H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(d)).

26. H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(c)-(d)); H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(b)-(d)).

27. See H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(a)(3)(C), (c)(1)); H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(a)).

28. See H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(d)); H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(b)-(c)).

29. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1391(a)).

30. *Id.*

31. *Id.*

32. *Id.* (proposing I.R.C. § 1391(b)). Ten zones are designated in the first year, and five every year thereafter. *Id.* (proposing I.R.C. § 1391(b)(2)(A)).

33. *Id.* (proposing I.R.C. § 1391(d)).

modified the boundaries of the enterprise zone, or has failed to comply with the required course of action.<sup>34</sup>

The Secretary of HUD designates a nominated area using specific selection criteria contained in the proposed statutes.<sup>35</sup> An area is eligible for enterprise zone designation only if the area meets six requirements. First, the nominated area must have a population of over 4000 people.<sup>36</sup> Second, the nominated area must be one of pervasive poverty, unemployment, and general distress.<sup>37</sup> Third, the nominated area may not exceed twelve square miles.<sup>38</sup> Fourth, the unemployment rate must be one and one-half times the national unemployment rate or more.<sup>39</sup> Fifth, the poverty rate of the zone must be 20% or more.<sup>40</sup> The sixth requirement is a proposed "course of action" that will be implemented by the state and local governments and private non-governmental entities.<sup>41</sup> No course of action may be funded from the proceeds of any federal program.<sup>42</sup>

The "course of action" requirement is designed to require state and local government contributions to the enterprise zone. There are nine specified courses of action that may be implemented on the local level. Of the nine, only two courses of action are absolutely required.<sup>43</sup> Of the remaining seven, one must be implemented.<sup>44</sup> However, the

34. *Id.* (proposing I.R.C. § 1391(d)(2)). There is nothing in H.R. 11 revoking an enterprise zone designation if the area became successful. That is, if a zone created such economic activity that unemployment fell below the national average, or the poverty rate was below the required 20% among all the residents of the zone, zone designation of that area would continue. Thus, after zone designation is made and the area is selected, it can be revoked only if the state or local government significantly modifies its boundaries, or they do not comply with the program requirements. *See id.* (proposing I.R.C. § 1391(d)(2)). Perhaps the drafters of the bill concluded that if an area became successful through zone selection, it should be left alone rather than possibly retarding that success by revoking designation. On the other hand, it seems logical to say that at some point the businesses must be weaned from the federal tax incentives and be able to survive without the government's subsidy. If by year ten a particular zone is a success, it is an inefficient use of tax dollars to continue the subsidy.

35. *Id.* (proposing I.R.C. § 1392(a)).

36. *Id.* (proposing I.R.C. § 1392(b)(1)(A)).

37. *Id.* (proposing I.R.C. § 1392(b)(1)(B)). Exactly what constitutes an area of pervasive poverty and general distress is not explained in H.R. 11. Perhaps this is a matter to be explained in future regulations.

38. *Id.* (proposing I.R.C. § 1392(b)(1)(C)(i)).

39. *Id.* (proposing I.R.C. § 1392(b)(1)(D)).

40. *Id.* (proposing I.R.C. § 1392(b)(1)(E)). The poverty rate must be 20% or more for 90% or more of the census tracts in the proposed enterprise zone. *Id.*

41. *Id.* (proposing I.R.C. § 1392(b)(1)(F)).

42. *Id.*

43. *Id.* (proposing I.R.C. § 1391(b)(2)(H)-(I)).

44. *Id.* (proposing I.R.C. § 1391(c)(1)(B)).

greater the number implemented, the greater the area's chances of receiving the designation from HUD.<sup>45</sup>

The proposal first requires that states establish a program to encourage local financial institutions to make loans to tax enterprise zone businesses.<sup>46</sup> The financial institutions are to be encouraged to use these loans to satisfy their obligations under the Community Reinvestment Act of 1977. The proposal next requires the states to give special preference to (1) qualified low-income housing projects located in tax enterprise zones in the allocation of the state housing credit ceiling under I.R.C. § 42, and (2) facilities located in tax enterprise zones in the allocation of the state ceiling on private activity bonds under I.R.C. § 146.<sup>47</sup>

The other seven courses of action are: reducing state and local tax rates within the enterprise zone;<sup>48</sup> increasing the level and efficiency or delivery of local public services within the enterprise zone;<sup>49</sup> reduc-

45. See *supra* note 28 and accompanying text.

46. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(c)(2)(H)).

47. *Id.* The Community Reinvestment Act of 1977 requires financial institutions to demonstrate that they are serving the needs of the community in which they do business. 12 U.S.C. § 2901(a) (1988). A bank's failure to comply with the Community Reinvestment Act affects the bank's status as a federal deposit facility. *Id.* § 2901(b). If an enterprise zone business came to a local bank for a loan, and another business with similar qualifications but not located within the enterprise zone also sought a loan, H.R. 11 gives preference to the enterprise zone business. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(c)(2)(I)).

48. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(c)(2)(I)). Under I.R.C. § 42(a), a § 38 credit is available for low income housing. I.R.C. § 42(a) (1991) (unless otherwise stated, all references to the Internal Revenue Code will be to the 1986 Code, as amended and in effect for 1991). To be eligible for the credit, the taxpayer must receive a credit allocation from the state. See I.R.C. § 42(h)(1)-(3). Each state has a ceiling on the amount of credit that can be used for low-income housing in that state. See I.R.C. § 42(h)(3)(C). Proposed I.R.C. § 1392(c)(2)(I)(i) of H.R. 11 requires that states give preference in allocating that credit to low income housing in enterprise zones. See H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(c)(2)(I)(i)). The low-income housing tax credit is scheduled to expire on December 31, 1991 and would have to be extended should H.R. 11 be enacted.

I.R.C. § 146 deals with private activity bonds, qualified small issue bonds, redevelopment bonds, or bonds to finance certain other private activity. The interest income from these bonds are exempt from federal taxation. I.R.C. § 103. States also have a ceiling on the amount of private activity bonds that can be written. See I.R.C. § 146. The states can allocate the amount of qualified private activity bonds. See I.R.C. § 146(e). I.R.C. proposed § 1392(b)(2)(I)(ii) of H.R. 11 would mandate preference in the allocation to projects in enterprise zones being financed by private activity bonds. See H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(b)(2)(I)(ii)).

49. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(c)(2)(A)).



ing or streamlining government paperwork;<sup>50</sup> involvement in the enterprise program by public authorities or private entities, organizations, neighborhood associations, and community groups, including written commitments to provide jobs or job training and other assistance to employers and employees in the nominated area;<sup>51</sup> giving special preference to contractors owned and operated by minorities;<sup>52</sup> gifting land in the enterprise zone to neighborhood organizations who agree to operate a business on the land;<sup>53</sup> and, finally, establishing a program under which employers within the enterprise zone may purchase health insurance for their employees on a pooled basis.<sup>54</sup>

In summary, under House Bill 11 a nominated area must meet several specific selection criteria to be eligible for enterprise zone designation.<sup>55</sup> Following the nomination and a determination that the eligibility requirements are met, the area must still be selected by the Secretary of HUD to obtain the enterprise zone designation.<sup>56</sup>

The Secretary uses five factors, all of which receive equal weight, in selecting the enterprise zone.<sup>57</sup> The factors are: (1) The strength and quality of the promised course of action by the state and local governments;<sup>58</sup> (2) the effectiveness and enforceability regarding the course of action to be carried out;<sup>59</sup> (3) the level of commitments of additional resources and contributions by private entities to the economy of the area;<sup>60</sup> (4) a ranking based on the level of poverty and

50. *Id.* (proposing I.R.C. § 1392(c)(2)(B)). Interesting differences exist in both bills compared to the original idea put forth by Peter Hall. Hall, who is credited as being the founder of enterprise zones, called for reducing social services within enterprise zones. *See* Hall, *supra* note 10, at 418. Hall envisioned reducing the cost to businesses who operated in an enterprise zone in order to make the zones competitive with the cheap labor found predominately in third world countries. *See id.* Taking the opposite position, the enterprise zone legislation in America calls for increases in social and public services in enterprise zones. The American philosophy may be that adequate social and public services are a strong factor in a business's decision to locate. *See generally* COMPTROLLER GENERAL OF THE UNITED STATES, REVITALIZING DISTRESSED AREAS THROUGH ENTERPRISE ZONES: MANY UNCERTAINTIES EXIST (1982) (analyzing and critiquing factors for enterprise zones) [hereinafter REVITALIZING DISTRESSED AREAS].

51. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(c)(2)(C)).

52. *Id.* (proposing I.R.C. § 1392(c)(2)(D)).

53. *Id.* (proposing I.R.C. § 1392(c)(2)(E)).

54. *Id.* (proposing I.R.C. § 1392(c)(2)(F)).

55. *Id.* (proposing I.R.C. § 1392(c)(2)(G)).

56. *Id.* (proposing I.R.C. § 1392(b)).

57. *See id.* (proposing I.R.C. § 1392(a)).

58. *Id.* (proposing I.R.C. § 1392(d)).

59. *Id.* (proposing I.R.C. § 1392(d)(1)).

60. *Id.* (proposing I.R.C. § 1392(d)(2)).

unemployment;<sup>61</sup> and (5) the potential for the revitalization of the nominated area as a tax enterprise zone.<sup>62</sup>

### B. *Designation Under House Bill 23*

The designation procedure under House Bill 23 is similar to House Bill 11. First, state and local governments must nominate the area as a potential enterprise zone.<sup>63</sup> Next, the area must meet certain eligibility requirements.<sup>64</sup> Finally, the Secretary must designate an enterprise zone.<sup>65</sup> Once designated, the special status remains in force for twenty-five years.<sup>66</sup> A designation can be revoked by the Secretary of HUD upon a finding that the state or local government is not complying with the required course of action.<sup>67</sup>

The maximum number of designations permitted under House Bill 23 is fifty, and the designations must be spread over a four year period.<sup>68</sup> This bill requires one-third of the zones must be rural. Rural is defined as areas having a population of less than 50,000 people, located outside of a metropolitan area.<sup>69</sup>

House Bill 23 imposes both area and eligibility requirements for zone designation. There are three area requirements.<sup>70</sup> First, the potential zone must be within the jurisdiction of a local government.<sup>71</sup> Next, the boundary of the area must be continuous.<sup>72</sup> Finally, the population must be at least 4000 if any portion of the area is located within a metropolitan statistical area of greater than 50,000.<sup>73</sup> If the

61. *Id.* (proposing I.R.C. § 1392(d)(3)).

62. *Id.* (proposing I.R.C. § 1392(d)(4)). How the ranking is determined is not specified in H.R. 11. Section 104 of H.R. 11 calls for HUD to issue regulations within four months after the bill's enactment. *Id.* § 104(b). One specific regulation calls for establishing a method for comparing and weighing the selection criteria factors listed in proposed I.R.C. § 1392(d). *Id.* § 104(b)(2).

63. *Id.* (proposing I.R.C. § 1392(d)(5)). Again, the specifics of measuring the potential for rehabilitation are left to selection criteria regulations issued by the Secretary of HUD. *Id.* § 104(b)(2).

64. *Id.* § 101(a) (1991) (proposing I.R.C. § 7880(a)(1)(A)).

65. *Id.* (proposing I.R.C. § 7880(c)(1)).

66. *Id.* (proposing I.R.C. § 7880(a)(2)).

67. *Id.* (proposing I.R.C. § 7880(b)).

68. *Id.* (proposing I.R.C. § 7880(b)(2)).

69. *Id.* (proposing I.R.C. § 7880(a)(3)(C)(i)).

70. *Id.* (proposing I.R.C. § 7880(a)(3)(C)(ii)).

71. *Id.* (proposing I.R.C. § 7880(c)(2)).

72. *Id.*

73. *Id.*

area is not located in a metropolitan statistical area, the population must be at least 1000.<sup>74</sup>

The eligibility requirements under House Bill 23 for enterprise zone selection are similar to those of House Bill 11, requiring pervasive poverty, unemployment, and general distress.<sup>75</sup> The unemployment rate, like House Bill 11, must be at least one and one-half times the national unemployment rate.<sup>76</sup> The poverty rate cannot be less than 20%.<sup>77</sup> House Bill 23 imposes two additional eligibility requirements not found in House Bill 11. First, the area must be located wholly within the jurisdiction of a local government that is eligible for federal assistance under 42 U.S.C. § 5318.<sup>78</sup> Second, one of the following criteria must also be met: (1) "Not less than seventy percent of the households living in the area have incomes below eighty percent of the median income of households of the local government . . ." or (2) "the population of the area decreased by twenty percent or more between 1970 and 1980. . . ."<sup>79</sup>

The eligibility requirements for rural enterprise zone designation are considered less strict because fewer criteria must be met. Like the non-rural enterprise zones, a rural zone must be an area of pervasive poverty, unemployment, and general distress. The area also must be eligible for federal assistance under 42 U.S.C. § 5318. Finally, the area must meet at least one of the other three factors in proposed

74. *Id.*

75. *Id.*

76. *Id.* (proposing I.R.C. § 7880(c)(3)(A)). These terms are not defined in the bill. Presumably the regulations following the passage of the bill will explain the terms.

77. *Id.* (proposing I.R.C. § 7880(c)(3)(C)).

78. *Id.* (proposing I.R.C. § 7880(c)(3)(D)).

79. *Id.* (proposing I.R.C. § 7880(c)(3)(B)). 42 U.S.C. § 5318(b) provides criteria and standards for urban development action grants made to cities and urban counties.

[I]n the case of a city with a population of 50,000 or more, or an urban county [the area receiving the grant] contains an area (i) composed of one or more contiguous census tracts, enumeration districts, neighborhood statistics areas, or block groups as defined by the United States Bureau of the Census having at least a population of 10,000 persons or 10[%] of the population of the city or urban county; (ii) in which at least 70[%] of the residents have incomes below 80[%] of the median income of the city or urban county; and (iii) in which at least 30[%] of the residents have incomes below the national poverty level.

42 U.S.C. § 5318(a)(A) (1988). In a city with a population less than 50,000, the requirements are essentially similar except the area receiving the grant needs only a population of either 2500 or 10% of the population. *Id.* § 5318(b)(2)(B). Under H.R. 23, eligibility for a zone requires the zone meet the same requirements as outlined above, depending on the zone's population. H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(c)(3)(B)).

I.R.C. § 7880(c) (3) of House Bill 23, while non-rural areas must meet all three.<sup>80</sup>

House Bill 23 requires state and local governments to commit, in writing, to the Secretary of HUD, that they will follow a specified course of action. Like House Bill 11, a House Bill 23 course of action suggests adjustments in state and local taxes;<sup>81</sup> reductions and simplifications of governmental regulation within the zone;<sup>82</sup> increased efficiency in providing government services;<sup>83</sup> active involvement by private entities in job training and technical assistance to all inhabitants of the nominated area;<sup>84</sup> “mechanisms to increase equity ownership by residents and employees within the enterprise zone”;<sup>85</sup> and “donation (or sale below market value) of land and buildings to benefit low and moderate income residents.”<sup>86</sup> House Bill 23 also calls for “linkages to job training, transportation, education, day care, health care, and other social service support”;<sup>87</sup> “provision of supporting public facilities, and infrastructure improvements”;<sup>88</sup> “encouragement of local entrepreneurship”; and “other factors determined essential to support enterprise zone activities and encourage livability or quality of life.”<sup>89</sup>

After nomination and satisfaction of the eligibility requirements, the final step is designation by the Secretary of HUD.<sup>90</sup> Designation of the zone will be made after consultation with the appropriate agency heads enumerated in the proposal.<sup>91</sup>

Priority for enterprise zone designation by the Secretary is based on four factors: (1) The quality of the course of action chosen by the local government especially considering tax adjustments;<sup>92</sup> (2) the likelihood that the proposed course of action will occur;<sup>93</sup> (3) the level of

80. H.R. 23, 102d Cong., 1st Sess. (1991) (proposing I.R.C. § 7880(c)(3)(E)).

81. *Id.* (proposing I.R.C. § 7880(c)(4)); *see id.* (proposing I.R.C. § 7880(c)(3)).

82. *Id.* (proposing I.R.C. § 7880(d)(2)(A)).

83. *Id.* (proposing I.R.C. § 7880(d)(2)(B)).

84. *Id.* (proposing I.R.C. § 7880(d)(2)(C)).

85. *Id.* (proposing I.R.C. § 7880(d)(2)(D)).

86. *Id.* (proposing I.R.C. § 7880(d)(2)(E)).

87. *Id.* (proposing I.R.C. § 7880(d)(2)(F)).

88. *Id.* (proposing I.R.C. § 7880(d)(2)(G)). What “linkages” means in this context is unclear and will hopefully be clarified in regulations.

89. *Id.* (proposing I.R.C. § 7880(d)(2)(H)).

90. *Id.* (proposing I.R.C. § 7880(d)(2)(I)-(J)). H.R. 23 calls for the publication of specific regulations in this area within four months following enactment of the bill. *Id.* (proposing I.R.C. § 7880(a)(3)(A)).

91. *See id.* (proposing I.R.C. § 7880(a)).

92. *Id.* (proposing I.R.C. § 7880(a)(1)(B)).

93. *Id.* (proposing I.R.C. § 7880(e)(1)).

commitments made by private entities;<sup>94</sup> and (4) the likelihood that the proposal will succeed.<sup>95</sup> The designations can be revoked if there is a lack of compliance with the proposed course of action.<sup>96</sup>

### C. *Analysis of the Designation Procedures*

The procedures for nominating an area in each of the bills are not significantly different. The relative strengths of each of the differences between the two proposals will be discussed first. The analysis will then focus on problems common to both bills.

House Bill 11 limits the designation to twenty-five zones<sup>97</sup> while House Bill 23 allows fifty.<sup>98</sup> There may be an advantage to limiting enterprise zones to twenty-five, as it provides a "test run" on enterprise zones while keeping the cost of the program down.<sup>99</sup> If enterprise zones succeed as a concept, the number can be increased in the future. However, if enterprise zones fail, fewer zones means less waste.

The eligibility requirements utilized by the two bills are roughly similar. Both require the same unemployment rate.<sup>100</sup> The poverty rate may differ between the two proposals.<sup>101</sup> House Bill 11 limits the size of the zone to twelve square miles.<sup>102</sup> House Bill 23 does not have any specific size restrictions.<sup>103</sup>

94. *Id.* (proposing I.R.C. § 7880(e)(2)).

95. *Id.* (proposing I.R.C. § 7880(e)(3)).

96. *Id.* (proposing I.R.C. § 7880(e)(4)). The regulations will likely spell out what will constitute "success." Like H.R. 11, H.R. 23 does not mention any change in zone designation if the zone is successful. Presumably, if the zone is successful, zone designation stays the same.

97. *Id.* (proposing I.R.C. § 7880(b)(2)). Like H.R. 11, H.R. 23 allows revocation of zone designation by the Secretary of HUD only if the Secretary specified the date of revocation at the time of designation, or the state or local governments are not complying with the program. *Id.*

98. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1391(b)(1)).

99. H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(a)(3)(C)(i)(I)).

100. The cost of both programs is estimated to be around \$1.04 billion. *See Enterprise Zone Program and Its Impact on Small Business Growth and Development: Hearings Before the Senate Subcomm. on Small Business*, 101st Cong., 1st Sess. 15 (1989) [hereinafter *Enterprise Zone Hearings*]; *infra* note 215 and accompanying text. However, this figure is probably incorrect for H.R. 23, as H.R. 23 creates twice as many zones as H.R. 11, and does not have ceiling limits to control costs.

101. H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(c)(3)(C)); H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(b)(1)(D)).

102. Compare H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(c)(3)(D)) (indicating all census tracts must pass the statutory test) with H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(b)(1)(E)) (indicating only 90% of census tracts need pass the statutory test).

103. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(b)(1)(C)(i)).

House Bill 11 has a seeming advantage in its designation process because it mandates that in the course of action states must perform specific acts and must allocate current federal investment incentives to enterprise zones. For example, capital may become available to startup businesses by encouraging compliance with the Community Reinvestment Act. Affordable housing for residents of the zones is more likely because of the mandate that states give preference in the allocation of the low income housing credit. Finally, private activity bond ceilings allocated to enterprise zones may provide these areas with better services.

An examination of House Bill 23, the administration's bill, shows that it lacks specific directives. It does not require compliance with the Community Reinvestment Act, or give preference to enterprise zones in the allocation of low income housing credits or private activity bonds. House Bill 23, therefore, is not as specific as House Bill 11 in its attempts to ensure economic recovery in enterprise zones.

A major fault with House Bill 23 and House Bill 11 is the lack of specificity with regard to the provision of employment assistance by private entities. The selection process in both bills calls for private entities, community organizations, and neighborhood associations to provide job training and technical and financial assistance to employees and employers of the enterprise zones.<sup>104</sup> State and local governments can even seek to have these entities and community groups provide written commitments.<sup>105</sup> But neither bill provides alternatives with which local governments can guarantee or entice commitments from private entities.

It seems unlikely that many private entities in enterprise zones will undertake such commitments. Most potential enterprise zones do not have many businesses operating within their boundaries. Thus, the availability of entities is limited and should not be relied upon to provide this assistance. A new, small business is not likely to undertake the expense of job training.

Community groups may provide some help, but, because most of their work is voluntary, reliable commitment should not be expected. Also, community groups are usually charitable organizations whose ability to provide assistance is correlated to contributions. Therefore, if the community groups lack adequate funding for a particular year, the job training or other assistance will not be provided.

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104. See H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(c)(2)(C)).

105. See *id.* (proposing I.R.C. § 7880(d)(2)(D)); H.R. 11, 102d Cong., 2d Sess. § 101(a) (1991) (proposing I.R.C. § 1392(c)(2)(D)).

The basic problem in both proposals is lack of assurance that a critical need of zone residents will be provided. Many jobs require job training or special skill. Job training is at least partially responsible for the success of some state enterprise zone programs and is necessary in the proposed federal program.<sup>106</sup> Many of the unemployed in urban areas lack job skills or education. Without training to give employees these fundamental tools, many jobs are unavailable.<sup>107</sup> Given the importance of job training and technical assistance, both bills rely too heavily on the possibility that job training and technical assistance provided by private entities and community groups will be available or adequate. Private entities and community groups may not be willing (or able) to step forward to provide this important assistance.

The lack of adequate job training and assistance for the zone residents might unbalance the enterprise zone equation. On one side of the equation, businesses will have incentives to come into areas of economic distress, start businesses, and hire zone residents. On the other side of the equation, zone residents may be under-qualified and thus not employable. If this is the case, the owner of a small startup business within a zone may have to go outside the zone to hire the employees. Such a result negates the intent of zone designation.

Therefore, it is necessary to require that job training and technical and financial assistance be provided by either the state, local, or more plausibly, federal government. Although this solution may not be palatable considering the budget deficits all governments face, it may be crucial to success in enterprise zones.

Another potential problem with both proposals is reliance on state and local governments to increase social and public services within the zone. The reason state and local government involvement in the enterprise zones is important is that businesses are not likely to locate in the area without significant contribution by government entities. A 1982 General Accounting Office report to Congress highlighted the importance of state and local commitments for a successful enterprise zone program.<sup>108</sup> The report stated that unless state and local govern-

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106. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(d)(2)(D)) (indicating any commitment, oral or written, is acceptable).

107. See *Enterprise Zones and Economic Revitalization: Field Hearing Before the Subcomm. on Economic Stabilization of the House Comm. on Banking, Finance, and Urban Affairs*, 101st Cong., 1st Sess. 132 (1989) [hereinafter *Field Hearing*].

108. See *Administration's Enterprise Zone Proposal and H.R. 6, the Enterprise Zone Improvements Act of 1989: Hearings Before the Comm. on Ways and Means, House of Representatives*, 101st Cong., 1st Sess. 189 (1989). In testifying before the House Ways and Means Committee, Brett Birdsong of the Urban Institute stated that the fastest growing business

ments can assure a business that other considerations such as crime rate, transportation, building security, lighting, and code enforcement will be satisfied, a business will not likely locate in that community.<sup>109</sup>

Adequate public services appear critical for a successful enterprise zone. Therefore, the ability of state and local governments to provide these services is significant. Unfortunately, many state and local governments are currently facing serious financial crises.<sup>110</sup> More than half the states are laying off public employees and making cutbacks in social services and public works.<sup>111</sup> With government-wide cutbacks, it may be very difficult for a state or local government to pledge increased public services in the designated area. If the success of enterprise zones is dependent on local governments providing services such as police and fire protection, drug enforcement, and transportation, then what happens to those governments that cannot afford to provide these services? Should the Secretary pass over an area that would clearly qualify for zone designation because the state and local governments cannot guarantee adequate social and public services?

A realistic appraisal of the economic and political feasibility of state and local governments ability to increase public services in enterprise zones is necessary. As the proposals now stand, the problem of providing better public services belongs to the state and local governments. State and local governments are thus forced to decide whether and how to increase public services in enterprise zones. Action on the part of state and local governments may entail an increase in local taxes or cuts in other state and local programs. Neither option would be popular. Alternately, the federal government may provide aid to those potential enterprise zones that cannot afford to increase public services. However, the federal deficit makes it unlikely the federal government will undertake such a task.

Another weakness shared by both bills is the revitalization potential of the zones which must be evaluated under the selection criteria.<sup>112</sup> Both bills lack specificity on how to determine revitalization potential

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sectors of most cities require even their lowest level employees to have at least a high school education. *Id.* (statement by Brett Birdsong, Research Assistant, The Urban Institute). Birdsong cited studies showing that at least 63% of the underclass drop out of high school. *Id.* Birdsong said research by the Urban Institute shows that the critical problem residents from underclass neighborhoods have in finding employment is their lack of job skills. *Id.*

109. REVITALIZING DISTRESSED AREAS, *supra* note 50, at 14.

110. *Id.* at 15.

111. Michael deCourcy Hinds & Erik Eckholm, *80's Legacy: States and Cities in Need*, N.Y. TIMES, Dec. 30, 1990, at 1, col. 1.

112. *Id.*



or the likelihood for success. House Bill 23 does attempt to evaluate the likelihood for success; it calls for the Secretary of HUD to consult with other agency heads during the selection process.<sup>113</sup> This provision is sound because success of an enterprise zone depends on several factors. The HUD Secretary can make a more informed decision after the required consultation with the other secretaries.

A recommended change to the selection process proposed by each bill would be replacing the Secretary of HUD with an Enterprise Zone Selection Board to make the final selection. The Board would be chosen by the President but kept independent from the executive branch of government. Independence from the executive branch is necessary to avoid the use of enterprise zones as a political reward or penalty. Currently, because the Secretary of HUD is the final authority, the award of an enterprise zone to a particular representative's district or a senator's state could be an effective bargaining chip for the administration.

### III. TAX AND INVESTMENT INCENTIVES FOR ENTERPRISE ZONES

Both enterprise zone proposals contain both tax incentives and investment incentives. The tax incentives are in the form of tax credits. Investment incentives are in the form of capital gains deferment (House Bill 11)<sup>114</sup> or exemption from tax (House Bill 23).<sup>115</sup> The goal of the tax incentives is to either make it more profitable for the employer to hire, or more profitable for the employee to find work. The goal of the investment incentives is to stimulate investment, primarily in the small, startup businesses in the enterprise zone.

#### A. *Tax Credits Under House Bill 11 and House Bill 23*

##### 1. House Bill 11 Enterprise Zone Employment Tax Credit

The employment tax credit is meant to encourage small businesses to hire residents of enterprise zones. A small employer in an enterprise zone gets a credit of 10% of the sum of the qualified zone wages paid, plus the qualified zone employee health insurance costs paid by the employer.<sup>116</sup> A small employer means any employer employing less

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113. See H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(d)); H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(d)).

114. H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(a)(1)(B)).

115. *Id.* (proposing I.R.C. § 1392(a)(1)).

116. *Id.* § 201 (proposing I.R.C. § 1393(a)).

than 100 people.<sup>117</sup> The credit is available only if the employee who works for the small employer lives within the tax enterprise zone and performs substantially all of the services within the tax enterprise zone.<sup>118</sup> If the employee earns over \$30,000 annually, that employee's wages are not eligible for the tax credit.<sup>119</sup> The credit is available for the first five years of employment with the employer.<sup>120</sup> The House Bill 11 employment tax credit would be a general business credit.<sup>121</sup> If the employer was not able to use the credit during a tax year, the credit could be carried back three taxable years and carried forward fifteen taxable years.<sup>122</sup>

## 2. House Bill 23 Employee Tax Credits

The House Bill 23 employee tax credit enables an enterprise zone employee to receive up to \$525 in credit or refunds.<sup>123</sup> Under House Bill 23, any employee who performs services, substantially all of which are within the enterprise zone and that are directly related to an enterprise zone business, receives a refundable tax credit.<sup>124</sup> The credit amount is 5% of the employee's qualified wages up to \$10,500.<sup>125</sup> But if the employee earns over \$20,000, the credit progressively phases out.<sup>126</sup> For example, if an enterprise zone employee earned \$20,000 in

117. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1394(a)(1)).

118. *Id.* (proposing I.R.C. § 1394(d)). To curb abuse, a parent corporation cannot have several subsidiaries operating in enterprise zones to take advantage of the enterprise zone credit. *Id.* (proposing I.R.C. § 1395(b)(1)). Proposed § 1395 treats controlled groups of corporations and chains of corporations connected through stock ownership with a common parent as one employer. *Id.* (proposing I.R.C. § 1395(b)(1)). Proposed § 1395 also treats all employees of partnerships or proprietorships which are under common control, as employed by a single employer. *Id.* (proposing I.R.C. § 1395(b)(1)).

119. *Id.* (proposing I.R.C. § 1394(c)). H.R. 11 does not contain special provisions restricting the tax credit to new enterprise zone employees. Thus, a qualified employee working in the zone prior to its designation will be allowed the tax credit after designation.

120. *Id.* (proposing I.R.C. § 1394(c)(3)).

121. *Id.* (proposing I.R.C. § 1394(c)(2)). An employer qualifies for the credit even if the employee was employed prior to enterprise zone designation. *Id.* Therefore, an employer need not hire a new employee after zone designation to get the credit. However, because the credit terminates after five years, the employer may terminate an employee as the employee approaches his fifth year. The employer would then hire a new employee in order to take advantage of the credit for another five years.

122. I.R.C. § 39(a)(1) (1991).

123. *Id.*

124. *See* H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1392(c)(1)(A)).

125. *Id.* § 201 (proposing I.R.C. § 1392(b)-(e)). The tax credit is refundable because it is treated as a subpart C credit. *Id.* (proposing I.R.C. § 1392(e)).

126. *Id.* (proposing I.R.C. § 1392(a)).

qualified wages in year one, then the employee would get a \$525 credit. If, in year two, the employee earned \$22,000, 10.5% of the wages over \$20,000, or \$210, is subtracted from \$525, leaving a credit of \$315. The credit is completely phased out if the employee makes \$25,000 or more.<sup>127</sup> Unlike House Bill 11,<sup>128</sup> House Bill 23 does not require that the employee live in the zone in order to receive the credit, nor is the credit limited by the size of the employer.<sup>129</sup> Further, the credit is not limited to a number of years.<sup>130</sup>

### 3. Evaluation of Tax Incentives

House Bill 11 and House Bill 23 both use tax credits to increase employment, although the proposals use different perspectives. House Bill 11 provides credits to the employer.<sup>131</sup> If the employer uses an enterprise zone worker for work in an enterprise zone business, the employer is rewarded. For instance, if the employer pays \$20,000 in wages to the employee, after taking account of the credit, this actually translates into paying the employee \$18,000. The employer realizes a 10% net savings. Similarly, House Bill 11 gives the employer a 10% credit for any health insurance provided to employees.<sup>132</sup>

House Bill 23, on the other hand, credits the employee.<sup>133</sup> An enterprise zone resident who finds employment within the enterprise zone is rewarded. If the employer pays the employee \$20,000, the employee gets \$525 of tax credit. The employer gets zero.

In terms of increasing employment, it is difficult to predict which credit is the most effective. House Bill 23 makes it more attractive for an employee to find work, particularly the employee who makes under \$20,000. Regardless of the tax liability of that employee, he will have up to \$525 more by being employed in an enterprise zone. Giving the employee the credit may also mean an employer can pay less wages, which provides an indirect wage subsidy.

Nonetheless, giving the employer the credit is probably more effective because it increases business profitability. The primary goal of the enterprise zone program is to encourage business activity within

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127. *Id.* (proposing I.R.C. § 1392(c)(1)).

128. *Id.* The employee credit is aimed at the low income worker. For example, the credit is not reduced up to a salary of \$20,000, but anything over \$20,000 is gradually phased out, becoming zero when the worker makes \$25,000. *Id.*

129. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1394(c)(1)(B)).

130. *See* H.R. 23, 102d Cong., 1st Sess. § 102 (1991) (proposing I.R.C. § 1392(b)(1)).

131. *See id.* (proposing I.R.C. § 1392).

132. *See* H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1394).

133. *Id.* (proposing I.R.C. § 1394(a)(1)(B)).

the zones. The more profitable a zone business is, through tax incentives or otherwise, the more likely the business will survive. If the business survives, it will employ zone residents. House Bill 11, by giving the credit to the employer, makes it easier for the startup business to hire employees, or to keep employees already on the payroll, because it directly reduces employment cost. As illustrated above, if an employee's yearly payroll costs the employer \$20,000, a 10% credit reduces that cost to \$18,000.

House Bill 23 incorrectly emphasizes the employee. The inner cities and rural areas of this nation targeted by the enterprise zone program suffer from unemployment. Generally, unemployment is caused by businesses being unable to afford to hire employees, not because the employee finds it unprofitable to work. Before the potential employee finds a job, there must be a demand for employees; there must be jobs. By giving the credit to the employer, there is a better chance that jobs will be available because the employment cost is reduced.

Whether employers will fully utilize the tax credits under House Bill 11 is another matter. In the past, businesses have not utilized tax credits, particularly non-refundable tax credits.<sup>134</sup> Even though the credit is available and easily obtained, past history of the WIN credits and the Targeted Jobs Tax Credit Program, shows that businesses, for whatever reason, did not utilize the credits.<sup>135</sup> Therefore, even assuming that businesses do hire enterprise zone employees, whether businesses will utilize the credit is subject to some doubt.

Perhaps businesses' past failure to use tax credits is linked to the fact that most small businesses, in the first years of operations, are short of capital and have little profit. A firm with little or no profit has little use for a tax credit. A 1982 General Accounting Office report on enterprise zones made the point that non-refundable tax credits are of limited value to small businesses because most small businesses

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134. H.R. 23, 102d Cong., 1st Sess. § 201 (1991) (proposing I.R.C. § 1392).

135. H.R. 11 employment tax credit is a general business credit and therefore, nonrefundable. The 1982 General Accounting Office (GAO) report on enterprise zones noted that business had not utilized a \$3000 credit for hiring disadvantaged workers under the 1979 Targeted Jobs Tax Credit Program (TJTC). *REVITALIZING DISTRESSED AREAS*, *supra* note 50, at 20-21. The TJTC, therefore, had little impact on hiring disadvantaged workers. *Id.* The other credit cited in the GAO report was the WIN credit started in 1971. *Id.* at 21. The WIN credit gave businesses a non-refundable 20% tax credit against a worker's first year wages if the worker was a welfare recipient. *Id.* Yet, in 1980 there were 53,000 WIN eligible employees, but only 20% were claimed by businesses for the WIN credit. *Id.*

incur little or no tax liability in the early years.<sup>136</sup> Thus, it is questionable whether businesses will have any use for the credit.<sup>137</sup>

A proposed amendment to House Bill 11 would allow the possible sale or lease of the credit to other businesses<sup>138</sup> or make the credit refundable.<sup>139</sup> If a business could sell or lease the tax credit, it would provide the struggling business in the enterprise zone with an immediate infusion of needed capital. The business could sell or lease credits to other enterprise zone businesses, or to those outside the zones. Although this would likely cause utilization of the credits, it would also certainly decrease federal revenues and therefore may be an unattractive alternative.

The Economic Recovery Tax Act (ERTA) of 1981 created a situation whereby a user of new depreciable capital equipment could transfer the tax benefits to third parties for cash by using a "safe harbor lease."<sup>140</sup> A form of safe harbor leasing in enterprise zones would allow a business with tax liability to receive cash from the credit. But, such a transfer of tax benefits is extremely unfair. A wealthy individual or corporation could buy the credits and end up paying no tax. The unfairness was a major reason safe harbor leasing was effectively repealed by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).<sup>141</sup>

Another suggestion would make the House Bill 11 employee tax credit refundable even if the employer has paid no taxes. While this suggestion may increase the cost of the program, a refundable credit will increase the capital available to fund continued operations in a young business. Considering the economic environment of the enterprise zone, this may be money well spent. A startup business located in an enterprise zone encounters more obstacles than a startup business outside the zone. Allowing the employer's business to use the credit whether or not there is any tax liability in that year increases

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136. *Id.*

137. *Id.* at 27-28.

138. A 1982 report on enterprise zones by the accounting firm of Coopers & Lybrand found that federal wage credits do not have a substantial impact on the cash flows of firms during their first several years of operation. Coopers & Lybrand Economic Studies Group, *The Impact of Enterprise Zone Tax Incentives on Selected Small Businesses*, Final Report Prepared for the U.S. Small Business Administration Office of Advocacy, Nov. 1982, p. 6. During early years, firms do not have tax liability and the credits are not refundable. Thus, the credits have no positive effect on firms. *Id.*

139. REVITALIZING DISTRESSED AREAS, *supra* note 50, at 27.

140. *Id.*

141. I.R.C. § 168(c)(8) (1981) (repealed 1982).

the chance of that employer's business staying in the zone and contributing to the area's economic growth. Allowing the credit to carry over to future years when the enterprise zone business has taxable income is helpful, but does not provide current capital. In sum, the extra cost of making the credit immediately available to a new zone employer is probably a wise investment.

If the proposal of House Bill 23 is followed, and the employee rather than the employer receives the credit, the credit should be restricted to zone residents. Currently, the credit is available to any enterprise zone employee.<sup>142</sup> To qualify as an enterprise zone employee, the employee only has to work in the enterprise zone — residency status is irrelevant.<sup>143</sup> Thus, the definition of an enterprise zone employee could lead to employment of those not targeted. Although employment may increase in the zone, it will not increase the employment of zone residents — the very people targeted by the bill.<sup>144</sup>

If the federal government gives tax benefits to certain citizens based upon geographical location, there is a possible constitutional issue concerning the uniformity clause.<sup>145</sup> An examination of the history of the uniformity clause shows that the drafters of the Constitution wanted to prevent Congress from favoring one state over another.<sup>146</sup> Nevertheless, case law may protect the constitutionality of enterprise zones. In dictum, the Court in *United States v. Ptasynski*<sup>147</sup> stated that although any tax which is defined in geographic terms will be examined closely for actual geographic discrimination, the courts will give considerable deference to Congress's judgment.<sup>148</sup>

142. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 209 (amending I.R.C. § 168(c)(8) (1981)).

143. H.R. 23, 102d Cong., 1st Sess. § 201 (1991) (proposing I.R.C. § 1392(b)).

144. *See id.* (proposing I.R.C. § 1392(b)(1)).

145. The goal of enterprise zones is to improve the economic activity in a zone which in turn will lead to employment of the residents of enterprise zones. Yet allowing residents from outside the zone to receive a credit harms the economy of the zone. The "non-zone resident" takes his earnings and spends the money on rent and in stores outside the zone, in effect taking money out of the zone economy. Situations will arise where a zone business cannot hire a qualified zone resident, and will have to look outside the zone, thus losing the credit. While this situation may occur, it does not dictate abandoning the overall goal of finding employment for zone residents. Because this goal is best achieved by zone businesses hiring zone residents, the loss of credit in these situations is acceptable.

146. "The Congress shall have the power . . . [t]o lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts, and excises shall be uniform throughout the United States. . . ." U.S. CONST. art. I, § 8, cl. 1.

147. *See Nelson Lund, The Uniformity Clause*, 51 U. CHI. L. REV. 1193, 1198 (1984).

148. 462 U.S. 74 (1983).

Invidious discrimination against a particular region is not the intent of enterprise zone legislation. Rather, the intent of Congress in giving favorable treatment to certain areas is to solve a geographical problem. Although constitutional concerns are warranted with any enterprise zone proposal, courts should defer to Congress under *Ptasynski*.

### B. *Investment Incentives*

Both enterprise zone proposals provide investment incentives through favored treatment on capital gains. House Bill 11 proposes referral of gain on the sale of a capital asset for nine years.<sup>149</sup> House Bill 23 proposes a gain exemption on the gain of enterprise zone property.<sup>150</sup> Corporate stock in enterprise zone businesses also is given special treatment.<sup>151</sup> House Bill 11 differs from House Bill 23 because it provides additional investment incentives in the form of tax credits for rehabilitating buildings and amortization of child care facilities.<sup>152</sup> House Bill 23 does not have a similar credit.<sup>153</sup>

#### 1. Rehabilitation Credits and Child Care Under House Bill 11

I.R.C. § 47 provides a 10% rehabilitation credit for expenditures incurred in rehabilitating a qualified building.<sup>154</sup> House Bill 11 gives the same credit if a building located in an enterprise zone which is at least thirty years old is rehabilitated.<sup>155</sup> The section 47 requirement that the building must have been placed in service before 1936<sup>156</sup> is not adopted in the enterprise zone credit. House Bill 11 also allows for the amortization of the basis of a child care facility, ratably over a period of sixty months.<sup>157</sup> The child care facility must primarily benefit the children of employees of the enterprise zones.<sup>158</sup>

House Bill 11's rehabilitation credit is designed to rehabilitate infrastructures in enterprise zones.<sup>159</sup> This credit is a plus to an enter-

149. *Id.* at 84-86.

150. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397(a)(1)).

151. H.R. 23, 102d Cong., 1st Sess. § 201 (1991) (proposing I.R.C. § 1393(a)).

152. *See* H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397A); H.R. 23, 102d Cong., 1st Sess. § 201 (1991) (proposing I.R.C. § 1394).

153. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1396(a)).

154. *See* H.R. 23, 102d Cong., 1st Sess. § 201 (1991) (proposing I.R.C. § 1392). H.R. 23 credits seem more targeted to employees, not employers. *See id.*

155. I.R.C. § 42.

156. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1396(a)).

157. I.R.C. § 47(c)(1)(B).

158. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1396(b)(1)).

159. *Id.* (proposing I.R.C. § 1396(b)(2)(B)).

prise zone proposal. As any visitor to this nation's inner cities can testify, the infrastructure often resembles a war ravaged city. Unfortunately, other provisions of the Internal Revenue Code may make the credit less attractive. Specifically, the passive activity limitations may offset the credit initiative.

Generally, I.R.C. § 469 allows the deduction of losses from passive activities only to the extent of the aggregate income from all passive activities.<sup>160</sup> Similarly, passive activity credits are permitted only to the extent of the taxpayer's tax liability from all passive activities.<sup>161</sup> Section 469 probably will apply to the rehabilitation credit if the taxpayer's activity constitutes a rental activity<sup>162</sup> or other passive activity.<sup>163</sup> Section 469(i) allows a taxpayer to take a passive activity credit up to a \$25,000 deduction equivalent against nonpassive income,<sup>164</sup> even if the taxpayer does not actively participate.<sup>165</sup> But any rehabilitation credit in excess of the \$25,000 deduction equivalent is only deductible to the extent of passive income.<sup>166</sup> Further, the amount of the credit is phased out if the taxpayers' gross income exceeds \$200,000.<sup>167</sup>

The current section 469 rules may decrease the attractiveness of rehabilitating a building because section 469(i) limits the credit available to offset nonpassive income to \$25,000. To illustrate the problem, suppose an investor in the 31% tax bracket wanted to rehabilitate a building with the intent of renting it to an enterprise zone business. At the 31% tax rate, the maximum credit equals \$7750.<sup>168</sup> If the rehabilitation expenses exceeded \$75,000, the value of the 10% credit is reduced because the investor is unable to credit more than \$7500 from the tax liability of nonpassive income.

160. 137 CONG. REC. E68 (daily ed. Jan. 3, 1991) (opening remarks of the sponsor of H.R. 11, Rep. Dan Rostenkowski).

161. I.R.C. § 469(d)(1).

162. *See* I.R.C. § 469(d)(2).

163. *See id.* I.R.C. § 469(c)(2)-4 provides that passive activity includes any rental activity, without regard to material participation.

164. *See id.* § 469(c)(1). Section 469(c)(1) provides that an activity is a passive activity if it involves the conduct of a trade or business and the taxpayer does not materially participate. *Id.*; *see also* Temp. Reg. § 1.469-5T (defining "material participation").

165. I.R.C. § 469(i)(1)-(2).

166. I.R.C. § 469(i)(6)(B).

167. *See* I.R.C. § 469(d)(2), (i)(2).

168. I.R.C. § 469(i)(3)(B). I.R.C. § 469(j)(5) defines the deduction equivalent of credits as "the amount which (if allowed as a deduction) would reduce the regular tax liability for such taxable year by an amount equal to such credits." *Id.* Since I.R.C. § 469(i)(2) limits the deduction to \$25,000 and this example assumes the taxpayer is already in the 31% tax bracket, then a



Likewise, the phase-out of the credit for taxpayers with a gross income exceeding \$200,000 is too restrictive when dealing with enterprise zone property. Many of the potential enterprise zone infrastructures are in such poor condition that they may be only attractive to those investors whose income exceeds \$200,000.

If the goal is to improve the infrastructure of the enterprise zones, the passive loss rules need reconsideration as applied to enterprise zones. The solution is to increase the offset allowed against nonpassive income. This solution may give some taxpayers more favorable tax treatment than others. However, if the goal is to improve the infrastructure of enterprise zones, favorable tax treatment for some is arguably not too high a price to pay.

The ability to amortize child care facilities is also a valid attempt to deal with a difficulty that working parents in enterprise zones will face: finding care for their children if they secure employment. Allowing an enterprise zone business to amortize the basis of a child care facility over a five year period is an extremely attractive investment incentive. For example, if a qualified child care facility is placed in service in year one, and the cost of the facility is \$60,000, the allowable deduction each month is \$1000.<sup>169</sup> The credit is available, however, only for facilities placed in service within the first nineteen years of enterprise zone designation.<sup>170</sup> A child care facility in existence prior to zone designation is not eligible for the credit.

House Bill 23, the administration's bill, does not provide any new tax incentives for rehabilitating buildings. Therefore, the rehabilitation credit is available only if the building is fifty-five years or older.<sup>171</sup> Child care provisions under House Bill 23 are left to the state and local governments. The proposal provides an incentive for state and local governments to address the child care problem by listing it as part of the selection criteria in the designation process.<sup>172</sup> Leaving

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\$7750 credit would reduce the tax liability by the same amount (\$7750) as a \$25,000 deduction at the 31% tax rate (\$7750).

169. On its face, the 60-month amortization of child care facilities would seem like a possible tax shelter. For example, a few investors could form a partnership to operate a child care facility in an enterprise zone. But the real purpose of the partnership would be to pass through the rapid amortization of a child care facility in an enterprise zone. The partners would be permitted a \$1000 deduction each month. However, the "at risk" rules of I.R.C. § 465 and the passive activity loss limitations of I.R.C. § 469 are not modified by H.R. 11. Thus, the taxpayer would find little advantage unless they put their money at risk and actively participated in the enterprise zone business.

170. H.R. 11, 102d Cong., 1st Sess. § 101 (1991) (proposing I.R.C. § 1396(b)(2)(A)).

171. I.R.C. § 47(c)(1)(B).

172. H.R. 23, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 7880(d)(2)(G)(iv)).

provision of child care to state and local governments raises the problem addressed earlier: are state and local governments able to encourage private entities or community groups to provide family services to working parents?

## 2. Capital Gains Investment Incentives

### a. House Bill 11: Deferral of Capital Gain Reinvested in Zone Property

Under House Bill 11, any individual with qualified reinvested capital gain may defer gain recognized either until the ninth year following the sale or exchange of the capital asset, or any earlier year the taxpayer chooses.<sup>173</sup> The total deferral amount cannot exceed a combined \$250,000 for all taxable years.<sup>174</sup>

Qualified reinvested capital gain is the amount of long-term capital gain realized from the sale or exchange of any capital asset "to the extent that the amount of such gain exceeds the excess of the amount realized . . . over the cost of any qualified zone property which is purchased by the taxpayer [within one year following the sale or exchange]."<sup>175</sup> Qualified zone property is any tangible property if substantially all of the use of such property is in an enterprise zone.<sup>176</sup> The qualified zone property definition includes a qualified zone equity investment.<sup>177</sup> Qualified zone equity investment is any stock in a corporation or a partnership interest, if the corporation or partnership will engage, or has engaged, substantially all of its activities in a trade or business in a tax enterprise zone.<sup>178</sup>

For example, Investor sells IBM stock for \$20,000 in which he had a basis of \$10,000. Investor has realized \$10,000 of capital gain. Assuming a 28% capital gains rate, Investor would normally pay \$2800 in tax in the year of sale or exchange. However, assume taxpayer wants to invest in an enterprise zone so he can defer the gain. Investor decides to purchase machinery for use in an enterprise zone business. This machinery is thus qualified zone property. The \$10,000 capital gain is qualified reinvested capital gain only if Investor invests the entire \$20,000 in the machinery. That is, qualified reinvested capital

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173. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397(a)).

174. *Id.* (proposing I.R.C. § 1397(b)).

175. *Id.* (proposing I.R.C. § 1397(c)(1)).

176. *Id.* (proposing I.R.C. § 1397(c)(2)(A)).

177. *Id.* (proposing I.R.C. § 1397(c)(2)(B)).

178. *Id.*

gain is the amount of capital gain realized, \$10,000 on the sale of the IBM stock, but only to the extent that the gain exceeds the excess of the amount realized, \$20,000, minus the cost of the machinery, \$20,000. If Investor had in earlier years deferred \$250,000 of capital gain, he would not qualify for deferring his gain in the current year or any subsequent year.

An almost identical result takes place if Investor, instead of buying machinery, wants to buy an enterprise zone equity investment. Assume Investor sells the IBM stock and purchases either stock in an enterprise zone corporation, or a partnership interest which conducts, or will conduct, substantially all its activities within an enterprise zone. If the amount realized, \$20,000, is reinvested in enterprise zone stock or an enterprise zone partnership interest, Investor defers the \$800 tax until year nine. Because of other provisions of the proposal, there is a significant advantage to Investor if he purchases stock rather than equipment in an enterprise zone business. If in year one, Investor purchased \$20,000 of enterprise zone stock, and in year nine the stock is worth zero, Investor gets to claim a \$20,000 ordinary loss.<sup>179</sup> Normally, Investor would have had \$20,000 capital loss.<sup>180</sup>

Under House Bill 11, an individual can defer capital gain only by reinvesting in enterprise zone property.<sup>181</sup> This provision prohibits corporations or partnerships from buying enterprise zone property and receiving a tax benefit. The purpose of this provision is to prohibit one individual from deferring more than \$250,000 of gain. Thus, an individual cannot buy enterprise zone property and defer \$250,000, and also use a controlled S corporation or partnership to receive an additional deferral.

Restrictions do apply to an investor electing to reinvest capital gains in qualified enterprise zone property. If a taxpayer disposes of qualified zone property within five years of purchase, any amount treated as qualified reinvested capital gain is recognized in the year

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179. *Id.* (proposing I.R.C. § 1397A(a)). An investor must hold the enterprise zone stock for five years before he can recognize an ordinary loss. *Id.* A new corporation must have been organized for the purpose of engaging in an enterprise zone business. *Id.* (proposing I.R.C. § 1397A(b)(1)(A)(ii)). Further, over the five years prior to the loss, at least 80% of the corporation's gross income must derive from the active conduct of a trade or business within an enterprise zone. *Id.* (proposing I.R.C. § 1397A(b)(1)(C)). These provisions prevent a corporation being formed for a tax shelter.

180. An ordinary loss is preferable to a capital loss because most taxpayers have more ordinary income than capital gain income.

181. *Id.* (proposing I.R.C. § 1397(a)).

of disposition.<sup>182</sup> In addition to termination of the deferral, the taxpayer incurs penalties for early sale or exchange. The tax is increased by interest determined at the underpayment rate under I.R.C. § 6621.<sup>183</sup> Also, a qualified zone equity investment ceases to be qualified zone property unless during the first five years from purchase 80% or more of the total gross income is derived from the active conduct of a trade or business within an enterprise zone.<sup>184</sup>

#### b. House Bill 23: Capital Gain Treatment

House Bill 23 excludes from gross income "enterprise zone capital gain."<sup>185</sup> Enterprise zone capital gain is defined as any gain that is classified as long-term capital gain, allocable in accordance with the rules under I.R.C. § 338(b)(5) to the sale or exchange of enterprise zone property.<sup>186</sup> The gain must be properly attributable to a period of use in an "enterprise zone business."<sup>187</sup> As to tangible property located in an enterprise zone, or any real property located in an enterprise zone, a taxpayer must hold the property for two years before

182. *Id.* (proposing I.R.C. § 1397(d)(1)(A)(i)).

183. *Id.* (proposing I.R.C. § 1397(d)(1)(A)(ii)). I.R.C. § 6621 underpayment rate is the sum of the federal short-term rate plus 3%. I.R.C. § 6621.

184. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397(d)(1)(B)(i)).

185. H.R. 23, 102d Cong., 1st Sess. § 201 (1991) (proposing I.R.C. § 1393(a)).

186. When an acquiring corporation purchases the stock of a target corporation, an election can be made to gross up the basis in the assets of the target. I.R.C. § 338. The target is treated as selling all of its assets for fair market value (FMV) on day one, and then repurchasing the assets for FMV on day two. *Id.* § 338(b)(3). The effect of this election is the target's assets equal FMV and should equal the price acquiring corporation paid for the stock. Section 338(b)(1)-(2) creates an adjusted gross up in basis (AGUB) in the target's assets. *Id.* § 338(b)(1)-(2). Section 338(b)(5) calls for the AGUB to be allocated among the target's assets as provided by the regulations. *Id.* § 338(b)(5). Temporary Treasury Regulation § 1.338(b)-2T divides assets into four classes. Class I is cash and cash like items. Temp. Treas. Reg. § 1.338(b)-2T. Class II assets are certificates of deposit, securities and similar items. *Id.* Class III assets are all assets of the target, both tangible and intangible. *Id.* Class IV assets are intangible assets in the nature of good will and going concern value. *Id.*

AGUB is reduced by Class I assets. The AGUB is then allocated among the Class II assets in proportion to their FMV. The remaining AGUB is allocated in the same manner among the Class III assets, and the remaining AGUB is allocated to the Class IV assets, goodwill and going concern. This eliminates controversy between the IRS and the taxpayer about the value to be placed on intangibles such as goodwill and going concern.

Section 338(b)(5) would only apply to enterprise zone capital gain in the event the taxpayer sold the entire business. Instead of selling the business's stock, the taxpayer must sell all the assets, cash, tangible and intangible property, and good will. Section 338(b)(5) would not apply if the taxpayer sold only a portion of his capital assets.

187. H.R. 23, 102d Cong., 1st Sess. § 201 (1991) (proposing I.R.C. § 1393(b)(1)(C)).

its sale or exchange for gain to qualify as enterprise zone capital gain.<sup>188</sup> Stock in an enterprise zone business is treated differently, as is explained below.

For a business to qualify as an enterprise zone business, five criteria must be met. First, the business must be an active trade or business within an enterprise zone with 80% of the gross income attributable to activities within the enterprise zone. Next, less than 10% of the business property may be stock, securities or property held for use by customers. Third, only an insubstantial amount of the property owned by the business may be collectibles. Fourth, substantially all of the business property must be located within the enterprise zone whether it is owned or leased by the business. Finally, substantially all of the business employees must work within the enterprise zone.<sup>189</sup>

An example may be helpful. Investor has saved \$100,000 and he thinks that investing in an enterprise zone is a wise investment decision. He decides that he would like to purchase I.R.C. § 1231 property in an enterprise zone. On January 1, 1993, Investor takes his savings and buys section 1231 property. Investor holds the property until January 1, 1995, when he sells the section 1231 property for \$200,000. Assuming that section 1231 gains exceed section 1231 losses, and ignoring any recapture, Investor has \$100,000 of gain. All of that gain is tax free.

Under House Bill 23, the purchaser of "enterprise zone stock" may deduct up to \$50,000 per year, up to a lifetime maximum of \$250,000, for the purchase of stock on the original issue.<sup>190</sup> "[E]nterprise zone stock means common stock issued by a qualified issuer," who uses the proceeds within twelve months from the issuance to acquire enterprise zone property.<sup>191</sup> Qualified issuers are subchapter C corporations which have only one class of stock, are solely engaged in one or more enterprise zone businesses, own or lease no more than \$5 million of property, and have over 20% of the voting power and over 20% of the value of the corporation owned by certain enumerated entities.<sup>192</sup> A qualified issuer can issue no more than an aggregate of \$5 million of enterprise zone stock.<sup>193</sup>

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188. *Id.* § 101(a) (proposing I.R.C. § 1393(b)(2)).

189. *Id.* (proposing I.R.C. § 1391(b)(1)).

190. *Id.* (proposing I.R.C. § 1394(a)-(b)).

191. *Id.* (proposing I.R.C. § 1394(e)(1)).

192. *Id.* (proposing I.R.C. § 1394(e)(2)).

193. *Id.* (proposing I.R.C. § 1394(e)(2)(B)).

These restrictions serve several purposes. First, they prohibit a new or existing corporation from issuing enterprise zone stock while using the proceeds outside the zone in another investment. For instance, a taxpayer cannot form a subchapter C corporation, issue stock, and use the proceeds from the stock to invest in other securities. Rather, the bill requires that the issuing corporation use the proceeds within twelve months to purchase property for use in the enterprise zone.<sup>194</sup> Second, the most a corporation can offer is \$5 million of stock.<sup>195</sup> By limiting the issuance to \$5 million and restricting an issuer to having no more than \$5 million in assets, this provision targets small businesses. The provision also keeps the cost of the program within some limits. Finally, the provision avoids tax shelters. By restricting the stock to one class, and prohibiting another corporation from owning more than 20% in the issuing corporation, a parent-subsidary arrangement which would enable one corporation to issue more than \$5 million of stock is not possible. That is, a parent corporation cannot issue \$5 million in stock and then have its subsidiary issue \$5 million of stock. The subsidiary would have more than 20% of its voting power held by another corporation and thus not meet the provision.

If Investor, instead of buying enterprise zone stock, contributes property to the corporation in exchange for the corporation's stock, Investor takes the stock with a basis equal to the fair market value of the contributed property and recognizes any lurking gain in the contributed property.<sup>196</sup> As an illustration, Investor contributes a building located in an enterprise zone with an adjusted basis of \$10,000 and a fair market value of \$20,000. Investor receives stock with a basis of \$20,000 and recognizes gain of \$10,000. This provision is necessary to prevent Investor from contributing property which has unrecognized gain, as in this example of \$10,000, and simultaneously taking a deduction of \$20,000.

The purchase of enterprise zone stock, although giving an immediate deduction to the purchaser, also reduces the stock's basis by the amount of the deduction taken.<sup>197</sup> If the taxpayer later disposes of the enterprise zone stock and takes a deduction, the gain is treated as ordinary income.<sup>198</sup>

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194. *Id.* (proposing I.R.C. § 1394(e)(1)).

195. *Id.* (proposing I.R.C. § 1394(e)(2)(B)).

196. *Id.* (proposing I.R.C. § 1394(f)(1)).

197. *Id.* (proposing I.R.C. § 1394(g)).

198. *Id.* (proposing I.R.C. § 1394(c)(1)).

House Bill 23's stock plan is, in effect, a non-interest-bearing loan by the government to the investor. Repayment of the loan depends on whether the enterprise zone is successful. If an investor takes \$10,000 and buys enterprise zone stock, the investor's initial basis is \$10,000. When the investor takes an allowed deduction under House Bill 23 of \$10,000, the basis is reduced to zero. The enterprise zone business has use of the \$10,000. If the business fails, taxpayer walks away, unable to take any further loss deduction. If the business succeeds, and in year nine taxpayer sells the stock for \$10,000, taxpayer must pay tax on the \$10,000 gain.

Like House Bill 11, House Bill 23 imposes penalties if the taxpayer disposes of the enterprise zone stock within five years of purchase.<sup>199</sup> The taxpayer must pay tax and interest computed under section 6621(a)(2).<sup>200</sup> If the issuer of the stock ceases to be a qualified issuer, or the issuer fails to invest the proceeds from the sale of stock in enterprise zone property, the taxpayer will recognize the amount of the previous deduction as ordinary income.<sup>201</sup>

### C. *Evaluation of Investment Incentives*

The foundation of the enterprise zone is built on the theory that tax incentives will create economic development. Any enterprise zone proposal must make it attractive for investors to invest. The investor has to believe that a significant advantage exists for investment in an enterprise zone. Attention is first directed to tax incentives in tangible and real property, followed by tax incentives for enterprise zone stock.

#### 1. Capital Gain Treatment of Zone Tangible Property and Real Property

House Bill 11 restricts capital gain preference to new investment in the enterprise zone.<sup>202</sup> This prevents a windfall to taxpayers who own property prior to zone designation. Under this proposal, a taxpayer may not hold a capital asset in an area prior to zone designation and, after the area is designated as a zone, sell the property and defer the gain.<sup>203</sup> The deferral is only available to property purchased as qualified zone property<sup>204</sup> which does not exist until after enterprise zone designation.<sup>205</sup>

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199. *Id.* (proposing I.R.C. § 1394(c)(2)).

200. *Id.* (proposing I.R.C. § 1394(c)(2)(A)).

201. *Id.* (proposing I.R.C. § 1394(d)(1)).

202. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397(c)(2)(B)(i)).

203. *Id.* (proposing I.R.C. § 1397(d)(1)(A)(i)).

204. *Id.* (proposing I.R.C. § 1397(d)(1)(B)(i)).

205. *Id.* (proposing I.R.C. § 1397(c)(2)(A)(i)).

House Bill 23 arguably leaves the door open for a tax windfall to those taxpayers who own capital assets in the zone prior to its designation. Assume the following: Investor bought a building in the Bronx in year one for a fair market value of \$100, taking a cost basis of \$100. In year two the Bronx is designated an enterprise zone, and the building is used in an enterprise zone business. If Investor sells the building for \$150 in year four, thus holding the property for the required two years, \$50 of capital gain will be exempt from income. Investor walks away with \$50 of gain on which he pays no tax, yet Investor has not made an investment in the zone's redevelopment. However, it is also true that the short two year holding period provides an incentive for the property owner to improve the property and quickly put it into service in the enterprise zone to take advantage of the preferential treatment. For example, assume that a property owner has property in an enterprise zone that is not currently used in an enterprise zone business. If the property owner realizes that by improving the property and putting it into service as an enterprise zone business, the property can be sold within two years at a significant tax savings, the owner may be enticed to make the property productive. This is a desirable result because it causes economic investment in an enterprise zone.

Because House Bill 11 gives investment incentives only to those investors who wish to defer capital gain, the bill fails to encourage a large number of potential investors from investing in enterprise zones. Assume House Bill 11 is adopted. Investor has saved \$10,000. Believing enterprise zones are a good investment, he wants to invest the money in depreciable property in a zone. House Bill 11 does not provide an incentive for Investor to take his savings and put that \$10,000 into the zone. House Bill 11 does not provide an incentive to invest income other than that from the sale or exchange of capital gain property. Providing a tax advantage allowing only those investors with capital gain may exclude certain investors who would otherwise invest in an enterprise zone.

Another potential difficulty that might arise under House Bill 11 is whether simply deferring gain on a capital asset will sufficiently motivate investors to reinvest in enterprise zones. For an investor, there are many uncertainties and risks to enterprise zones. First, there is the uncertainty whether enterprise zones will work. Second, investors are investing money in undesirable geographical locations, areas with histories of high crime, unemployment and poverty — not the first choice for most investors. Although an investor under House Bill 11 can take an ordinary loss on stock if it decreases in value, benefit for other enterprise zone property (property used in a trade



or business in an enterprise zone) does not exist. In sum, under House Bill 11, investing in enterprise zone property used in a trade or business is not strongly desirable because the tax savings are not significant enough to overcome the inherent investment risk.

House Bill 23 is more attractive to investors than House Bill 11. Assume House Bill 23 is in effect, and Investor purchases \$10,000 worth of depreciable property for use in a trade or business. Investor will receive a tax benefit if, at the time of sale or exchange, the property is section 1231 property, and thus qualifies as a capital asset. If the property qualifies as a capital asset, then Investor recognizes no gain on the sale. Tax-free gain is a significant savings, and makes the investment in enterprise zone property very attractive. Even if there is risk to the investor on the purchase of a tangible capital asset (stock is treated differently), if the investor invests his \$10,000 in section 1231 property, and after three years, its value is \$20,000, he can sell and walk away with tax-free gain of \$10,000. Although the bill could ideally be less restrictive as to the type of investment capital that it attracts, House Bill 23 provides enough significant tax savings to overcome the inherent risk of an enterprise zone investment and thus attract investment capital.

House Bill 11, by contrast, needs to provide more investment incentive. House Bill 11 provides nothing to the investor who does not have a capital gain, and this discourages many investors. One suggestion to improve investment incentive is the expanded use of an investment tax credit. Past enterprise zone legislation and present rural enterprise zone legislation contain investment tax credits.<sup>206</sup> Assume that House Bill 11 contained a credit similar to that of Senate Bill 686<sup>207</sup> which allows a 10% credit for property placed in service in an enterprise zone. If Investor took his \$10,000 of savings and purchased depreciable property in an enterprise zone for use in a enterprise zone

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206. The most recent enterprise zone legislation that used investment tax credits was H.R. 6, 101st Cong., 1st Sess. § 211 (1989). H.R. 6 contained an investment tax credit of 10% for investment in new enterprise zone construction property. *Id.* Enterprise zone construction property would have been § 1250 property located in an enterprise zone which was used by the taxpayer in the active conduct of a trade or business. S. 686, 102d Cong., 1st Sess. (1991), introduced by Senator Max Baucus of Montana, would also use a similar tax credit.

207. S. 686, 102d Cong., 1st Sess. § 202(c) (1991). S. 686 gives a 10% credit of the basis of rural enterprise zone property placed in service. *Id.* Zone property would include personal property or construction property. *Id.* Construction property would be residential rental or nonresidential real property, located in the enterprise zone and used by the taxpayer in the active conduct of a trade or business. *Id.* Construction property would have to be constructed, reconstructed, or rehabilitated by the taxpayer in order to be eligible for the credit. *Id.*

business, Investor could receive a 10% tax credit; a credit of \$1000. House Bill 11 suddenly becomes more attractive to more investors.

If House Bill 11 adds an investment tax credit, the limitations on zone incentives under proposed section 1397B of the act<sup>208</sup> could still control the cost of the program. For instance, if the act placed the total zone limit at \$10 million, the taxpayer would use a portion of that limit through the investment tax credit. Once the credit limit was reached, it would no longer be available. This is the same method by which House Bill 11 controls both the employment tax credit amounts and capital gain deferral amounts.

The "at risk" rules of I.R.C. § 465 also would limit the ability of investors to use the tax credit as a tax shelter.<sup>209</sup> If a partnership borrowed \$10,000 and purchased enterprise zone property, the credit would pass through to the partners only if partners were personally liable for the loan or pledged property.

As for House Bill 23, the investment tax credit is not needed. The nonrecognition of gain on the sale of a capital asset is a significant enough tax advantage by itself to entice investment in enterprise zone property. Allowing the investment tax credit would only increase the cost of the program.

It is easy to suggest an investment tax credit, but whether it will be added to a bill is a different matter. There is nothing in the legislative history indicating why prior bills included the investment tax credit, or why both proposals ignore the credit. A reasonable hypothesis is that an investment tax credit, like a capital gain preference, is a volatile political issue for Congress. The 1986 Tax Reform Act significantly repealed the investment tax credit and the capital gains preference on the theory that they were a tax shelter for the rich. Congress, particularly the Democratic side, probably will not be inclined to add a perceived tax shelter to a bill, even if it would lead to more investment in enterprise zones.

## 2. Enterprise Zone Stock

The tax benefit to an investor for investing in enterprise zone stock under either proposal is similar. Under House Bill 11, if Investor One sells IBM stock for \$20,000 and has \$10,000 of capital gain, Investor One has a potential \$2800 tax liability. By reinvesting the \$20,000 in enterprise zone stock, Investor One can defer the \$2800 tax for up to nine years.<sup>210</sup>

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208. See H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397B).

209. See I.R.C. § 465(a).

210. These calculations assume a 28% capital gains tax rate.

Under House Bill 23, if Investor Two takes \$10,000 of her savings and invests in enterprise zone stock, she can deduct the \$10,000 on her income tax return in the year of purchase. The result is that Investor Two pays \$2800 less tax. Because the basis in the stock is reduced by the amount of deduction taken, when the stock is sold Investor Two will recognize gain. Investor Two cannot sell the stock until after year five. Assuming the stock is sold at a gain, Investor Two will pay tax at the time of sale. Investor One has to invest \$20,000 and Investor Two only invested \$10,000, while both essentially saved \$2800 in tax.

If the business fails, and the stock becomes worthless, the government shares in the loss under both House Bill 11 and House Bill 23. Under House Bill 11, Investor One takes an ordinary deduction in the year of the loss.<sup>211</sup> Under House Bill 23, Investor Two, who took the deduction in year one, gets no further deduction.

Even with the tax incentives, and even though a loss is shared with the government, a significant question arises — just who is going to buy enterprise zone stock?<sup>212</sup> Investing in any new business is always filled with risk for the investor. The business does not have a track record, there is little information on whether the product is marketable, and often there is little information about the strength of management of the new enterprise. These are normal factors of risk for any business investment, but, as noted previously, an enterprise zone investment is subject to additional risk. Further, if the investment performs poorly, under both proposals Investor cannot bail out for a minimum of five years without recognizing gain and paying additional penalties.

Under both proposals, the question becomes: is it realistic to expect anyone to invest in a high risk enterprise for a 28% deferral of tax for nine years when the investor is committed to the investment for a minimum of five years? A definitive answer is unavailable, but it appears the answer is no. The risk of loss is offset somewhat by the ability of an investor to walk away from the investment taking an ordinary loss, or not paying tax because of an earlier deduction. But, even with the offsets, investors invest to make money. Enterprise

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211. See H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397A(a)).

212. HUD Secretary Jack Kemp, arguing for a cut in capital gain tax rates in enterprise zones, stated that seed capital for a new enterprise zone business would come from informal investors — friends and relatives. *Enterprise Zone Hearings*, *supra* note 100, at 154 (statement of HUD Secretary Jack Kemp). Secretary Kemp's statement is subject to doubt. Poor and unemployed families usually do not have family members or friends with sufficient risk capital to start a business.

zone stock must therefore compete for the investor's money with other investments that do not have the significant hurdles an enterprise zone business has.

Although the question of whether investors will invest in enterprise zone stock remains, the investor will likely find House Bill 23 to be more attractive when compared to House Bill 11. The investor who invests in enterprise zone stock will most likely be a small investor as an individual's investment is restricted to \$250,000 over a lifetime under both bills.<sup>213</sup> If an investor just sold IBM stock for \$20,000, and has \$10,000 of gain, \$2800 of tax is due. Will the small investor want to reinvest all \$20,000 into an enterprise zone just to defer the tax of \$2800? Unlikely, yet under House Bill 11, the investor must do just that to defer the \$2800 gain.<sup>214</sup> House Bill 23 does not demand such an investment from the investor, nor does House Bill 23 require that the investment capital come from the sale of a capital asset.

Under House Bill 23, the initial investment need not be made by proceeds from the sale of a capital asset. Such proceeds may be used, but much less restrictively. For example, Investor sold a capital asset for \$20,000, \$10,000 in gain was generated, and \$2800 of tax is owed to the federal government. Here, Investor could take \$10,000 of the amount realized from the sale of the asset and invest in enterprise zone stock. With the \$10,000 deduction generating a tax savings of \$2800, Investor effectively pays no tax on the sale of the asset in the current year. Investor still has \$10,000 left from the sale of his asset to use as he chooses. In sum, House Bill 23 allows Investor to invest less money and receive the same tax benefit. It also allows an investor the opportunity to invest capital other than capital gain. These benefits to investors are significant when one considers the inherent risk investors face when putting their money into enterprise zone businesses.

#### D. Cost

The cost of both proposals is put at \$1.04 billion over a period of four years.<sup>215</sup> House Bill 11 contains a detailed and significant attempt to keep the cost of enterprise zones within a set budget.

As part of the designation procedure, the local governments and the state in which the nominated area is located must designate a government official who will be responsible for allocations under pro-

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213. See H.R. 23, 102d Cong., 1st Sess. § 201 (1991) (proposing I.R.C. § 1394(b)(1)); H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397(b)(1)(A)(ii)).

214. H.R. 11, 102d Cong., 1st Sess. § 101(a) (1991) (proposing I.R.C. § 1397(a)(1)).

215. *Enterprise Zone Hearings*, *supra* note 100, at 158.

posed I.R.C. § 1397B.<sup>216</sup> The allocation official has been labeled a “zone czar.” The czar has the authority to allocate employment credits, rehabilitation credits, child care amortization amounts, capital gain deferral amounts, special loss treatment, and other zone incentives in a manner that will likely result in the most economic activity in the zone.<sup>217</sup>

House Bill 11 creates a zone limit, or volume cap. The tax and investment incentives under House Bill 11, for a particular zone, cannot exceed the zone limit.<sup>218</sup> The zone limit is calculated by adding to the sum of \$10 million, the amount that bears the same ratio to \$50 million as the population of the zone bears to the total population of all zones.<sup>219</sup> Certain state and local expenditures can increase the zone limit. The zone limit increases by the lesser of 10% of the zone limit determined under proposed section 1397B(b)(2)(A) or the sum of state and local business incentives for the previous year, and the qualified state and local governmental expenditures for the prior year.<sup>220</sup>

Once a zone limit is determined, compliance is assured by reducing the amount of tax incentives available before the zone limit is exceeded by the tax and investment incentives used during the year. The zone limit cannot be reduced below zero. For instance, the employment credit reduces the zone limit by sixty-six cents for each dollar so allocated.<sup>221</sup> The capital gains deferral reduces the zone limit by seventeen cents for each dollar so allocated.<sup>222</sup> There is a special limitation on the aggregate amount of capital gains deferral allocated by the zone czar with respect to investments in any trade or business. The capital gain deferral on investments in enterprise zone cannot exceed \$5 million, reduced by the amounts so allocated in previous years.<sup>223</sup>

216. H.R. 11, 102d Cong., 1st Sess. § 101 (1991) (proposing I.R.C. § 1391(c)(2)(A)).

217. *Id.*

218. *Id.* (proposing I.R.C. § 1397B(b)(1)(A)).

219. *Id.* (proposing I.R.C. § 1397B(b)(2)(A)). For example, suppose that the population of zone A is 60,000 and the population of all zones is 2,500,000. The zone limit for zone A would be \$11,200,000 ( $\$10,000,000 + \$50,000,000 \times (60,000/2,500,000) = \$11,200,000$ ).

220. *Id.* (proposing I.R.C. § 1397B(b)(2)(B)). State and local business incentives include property tax or sales tax abatements provided by the state and local governments, grants made by the state and local governments, and 5% of the outstanding balance on loans made by state and local governments to start businesses. *Id.* (proposing I.R.C. § 1397B(b)(3)(A)).

Qualified state and local governmental expenditures include expenditures to improve public improvements and facilities, and increases in fire and police services, less the cost of those same expenditures in 1989, increased by the cost of living adjustment for the calendar year for which the increase is being determined. *See id.* (proposing I.R.C. § 1397B(b)(3)(B)).

221. *Id.* (proposing I.R.C. § 1397B(d)(1)(B)).

222. *Id.* (proposing I.R.C. § 1397B(d)(4)(B)).

223. *Id.* (proposing I.R.C. § 1397B(c)(1)).

The zone czar may elect to carry over unused credits.<sup>224</sup> For example, if the zone limit for year one is \$5 million, but the zone czar wishes to allocate only \$2.5 million to the zone, he can elect to carry over the remaining \$2.5 million to the next succeeding year.<sup>225</sup>

The volume cap ensures that the program stays within certain guidelines and does not ultimately cost more than anticipated. Because the response to the various tax and investment incentives is unpredictable, the volume cap acts as a type of safety net. The volume cap feature is a distinct advantage for House Bill 11 in that it provides insurance that costs will stay within some type of budget. House Bill 23 has nothing similar in the way of cost containment. Therefore, predictions that House Bill 23 will only cost \$1.04 billion are questionable. For instance, if there is a significant investment in enterprise zone stock, or significant use of the capital gain exemption from the sale of zone property, the cost of the program will increase, and there is nothing in the bill to check this possibility.

While maintaining a cap on the cost of the program is wise, allowing the zone czar to determine the allocation of tax incentives that will create the greatest economic development is suspect. Enterprise zones are by definition an attempt to let the free market operate to create economic opportunities in distressed areas. House Bill 11, by giving the zone czar the authority to allocate zone investment or incentive in a manner that he or she believes will create the most economic development, contradicts the notion of free enterprise. If the zone czar decides to allocate more housing credits to a zone for whatever reason, the decision ultimately may prove correct, but the meddling disrupts the free market. The zone czar may artificially create more rehabilitated buildings than necessary by allowing more rehabilitation credits. When the market creates demand for rehabilitated buildings, the demand is based on the law of supply and demand, rather than a bureaucratic decisionmaking process. Allowing the free market to operate by itself will eventually lead to the investments properly going into the needed areas. Initially, a free market policy may result in a greater deferral of capital gains (to cope with the need for investment capital), or perhaps more employment credit because of increasing employment. Whatever the result, the free market should discover for itself where the investment should go. If the zone czar makes such a decision, the analysis of where to invest may be inaccurate; thereby creating supply where there is not demand. Also, if the zone czar allocates investment,

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224. *Id.* (proposing I.R.C. § 1397B(b)(2)(C)).

225. *Id.* (proposing I.R.C. § 1397B(b)(2)(C)(ii)).

the decision will be subject to the political process that may taint the investment decision. In these scenarios, the credits are of little value. Volume caps are wise, but the zone czar should not have the ability to allocate credits.

The remaining question to consider is whether the cost of \$1.04 billion is worth the expected return. The hope is that enterprise zones will pay for themselves.<sup>226</sup> If enterprise zones do create jobs and business growth, there are two noticeable effects on the Treasury. First, less money is spent on welfare because some welfare recipients become self-supporting. Second, new jobs and business growth will mean more tax revenues coming into the Treasury.

#### IV. ENTERPRISE ZONES: WHO BENEFITS; THE POTENTIAL ECONOMIC EFFECTS AND WHY TAX INCENTIVES ALONE WILL NOT SOLVE THE PLIGHT OF THE INNER CITY

In 1981, Ronald Reagan implemented supply side economics by using large tax cuts to create economic growth. Although there were unfavorable consequences to Reagan's economics, clearly there was significant economic growth for most of the nation. However, the economic growth did not benefit the nation's most distressed areas. Thus, it is questionable whether and to what extent tax incentives will work in the inner cities through the enterprise zone concept. Further, who will benefit? Finally, what are the potential economic effects of enterprise zones? Some of these questions may be answered by examining past experiences with enterprise zones.

##### A. *Past Experiences with Enterprise Zones*

The optimist's position is that enterprise zone investment leads to revitalization that creates new jobs, increases municipal services provided by state and local governments, facilitates better housing through the housing credits, and rebuilds the inner cities. After examining the effect enterprise zones have had in England and in the various states, it is uncertain whether zones will help rebuild economically distressed areas.

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226. However, it is not at all certain enterprise zones will pay for themselves. In fact, they may be very expensive if past zones are examined. England's enterprise zones show that between 4% and 12% of the new firms would not have started but for the enterprise zone designation. David M. Maloney, *A Critical Analysis of the "Enterprise Zone" Concept and Its Application*, 34 TAX NOTES (TAX ANALYSTS) 261, 266 (Jan. 19, 1987). However, only 8000 new jobs were created at a cost of over \$500 million to the taxpayer, a cost of \$62,500 per job. *Id.*

### 1. The British Experience With Enterprise Zones

A review of the British experience with enterprise zones indicates that enterprise zones do not stimulate new economic activity of any significance. Two American Professors, John E. Schwarz and Thomas J. Volgy, arrived at that conclusion after studying a British enterprise zone.<sup>227</sup> On the surface, the research showed that the Dudley enterprise zone had been a large success.<sup>228</sup> In 1986, five years after its designation as an enterprise zone, 3300 more workers were employed and 160 employers had come into the zone.<sup>229</sup> The other enterprise zones in England had done even better, showing a 60% increase in employment overall.<sup>230</sup>

Schwarz and Volgy looked below the surface to reach their conclusions. Their determinations were made on the basis of interviews with businessmen in the enterprise zones.<sup>231</sup> Of the newly established businesses that Schwarz and Volgy visited in the zone, none of the businessmen said they had started their business because of the zone designation.<sup>232</sup> All would have started somewhere in the zone regardless of its designation or incentives.<sup>233</sup> The reason that Dudley attracted new businesses, the residents told the researchers, was availability of new, attractive, energy-efficient premises.<sup>234</sup>

The other enterprise zones in England had similar results.<sup>235</sup> Volgy and Schwarz cited a study done by Britain's Department of Environment that revealed that, in the country's eleven enterprise zones, the zones themselves stimulated little new economic activity or new employment.<sup>236</sup> Three out of four zone startup businesses would have come into the area without the zones.<sup>237</sup>

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227. John E. Schwarz & Thomas J. Volgy, *Experiments in Employment — A British Cure*, HARV. BUS. REV., Mar.-Apr. 1988, at 106. The study of the British enterprise zone centered on the city of Dudley, a West Highlands city of 300,000 where one in six workers were unemployed prior to the enactment of the enterprise zone. *Id.* at 105. In British enterprise zones the government lowered taxes, exempted gain on capital gains, and reduced government regulations. *Id.* This is similar to what would be done under the American proposals.

228. *Id.*

229. *Id.*

230. *Id.*

231. *Id.* at 106.

232. *Id.*

233. *Id.*

234. *Id.*

235. *Id.*

236. *Id.*

237. *Id.*



## 2. The Experience in the United States With Enterprise Zones

In the United States, as of 1989, thirty-six states had implemented enterprise zone programs.<sup>238</sup> For the most part, the states claim success for their enterprise zone programs.<sup>239</sup> For example, Minnesota claims that as of 1988 enterprise zones had created 5221 jobs and led to the retention of between 6000 to 8000 jobs.<sup>240</sup> Connecticut claims that its enterprise zones have created more than 13,000 jobs and \$400 million in new investment in enterprise zones.<sup>241</sup> Secretary of HUD Jack Kemp cited figures as high 100,000 new jobs retained, 68,000 jobs created, and over \$8.8 billion in new investment because of state enterprise zone programs.<sup>242</sup>

Debate continues about how much credit should be given to state enterprise zone programs. First, a business's decision to locate in an area is not necessarily influenced by tax incentives.<sup>243</sup> Surveys show that government-provided incentives, (e.g., low interest loans, property tax abatements, income tax credits) are of secondary importance to a firm's location decisions.<sup>244</sup> Primary factors for location decisions are markets, work force, transportation networks and availability of needed raw materials.<sup>245</sup>

The General Accounting Office's 1982 findings are further supported by a study of the Evansville, Indiana enterprise zone.<sup>246</sup> This study raises doubt about whether the tax incentives created economic development.<sup>247</sup> The study showed that approximately 1900 full-time jobs were generated in the Evansville enterprise zone between 1983 and 1986.<sup>248</sup> The authors concluded that approximately 1400 of those

238. *Enterprise Zone Hearings*, *supra* note 100, at 163.

239. *See id.* at 22-32.

240. *Id.* at 32.

241. *Id.* at 22.

242. *See Field Hearing*, *supra* note 107, at 132.

243. REVITALIZING DISTRESSED AREAS, *supra* note 50, at 10.

244. *Id.*

245. *Id.*

246. Barry M. Rubin & Margaret G. Wilder, *Urban Enterprise Zones: An Analysis of Employment Impacts and Fiscal Incentives*, in *Field Hearing*, *supra* note 107, at 187.

247. *Id.* at 210. The Evansville enterprise zone only had tax incentives, not investment incentives, such as preferential treatment for purchases of enterprise zone stock. *Id.* at 200. The authors of the study made their conclusion concerning the number of jobs created in enterprise zones by using a shift share analysis. *Id.* at 194. A shift share analysis decomposes change in economic activity into three components: the regional economic growth, the industry mix effect, and the competitive effect. *Id.* at 197-98.

248. *Id.* at 199.

jobs were created by the enterprise zone.<sup>249</sup> However, the authors could not link the increase in jobs directly to the tax incentives.<sup>250</sup> That does not mean tax incentives are without value, only that there is no direct relationship between incentives and the extent of new job creation.<sup>251</sup> The study suggested that offering tax incentives was a valuable marketing technique used by the city in getting business to locate in their zones.<sup>252</sup>

Because the lure of tax incentives by a state is a strong marketing tool, questions arise concerning just exactly what part tax incentives play in a decision to locate in the zone. State X creates an enterprise zone which may have, as one of its attractions, lower state income taxes and lower property taxes. State X then aggressively markets the enterprise zone to prospective businesses. Although State X can point to the zone and cite increased business activity and increased employment, what cannot be determined is what created that activity. Did businesses come to the zone because of the tax incentives, or because it was effectively marketed, or a combination of both?

A 1988 General Accounting Office study of the Maryland enterprise zone,<sup>253</sup> whose tax incentives closely resemble those of the proposed federal programs,<sup>254</sup> found other factors more important to business decisions to locate in Maryland enterprise zones than tax incentives.<sup>255</sup> The most important factors motivating the business location decisions were market access, and community and site characteristics.<sup>256</sup> Taxes ranked next to last as a reason why a company chooses its location.<sup>257</sup>

However, the Maryland and Indiana studies examined state tax incentives, not federal. It is difficult to predict employers' and employees' responses to potentially higher levels of federal tax incentives

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249. *Id.*

250. *Id.*

251. *Id.* at 210. Rubin and Wilder concluded that the enterprise zone did have a positive impact on the growth of employment. *Id.* at 209. But the increase in employment could not be linked to tax incentives. *Id.* at 210. Rather, the authors felt that the rise in employment in the enterprise zone might be attributed to political factors. *Id.* For example, offering tax incentives is a method by which the state promotes and encourages businesses to move into the zone. *Id.*

252. *Id.* at 213.

253. GENERAL ACCOUNTING OFFICE, ENTERPRISE ZONES: LESSONS FROM THE MARYLAND EXPERIENCE (1988). The GAO study on the effect of tax incentives on businesses in the Maryland zones was conducted by a mail survey of employers in the Maryland zones. *Id.* at 17.

254. *Id.* at 15.

255. *Id.* at 45.

256. *Id.* at 45-46.

257. *Id.* at 47.

because of the novelty of the new incentives. The response to federal tax incentives proposed is unpredictable because they are new incentives.

B. *The Potential Cost of Redirecting Investment, and Measuring Its Success*

Capital is a scarce resource and should be invested where it will provide the greatest possible return. By using the tax code to channel investments into enterprise zones, capital is taken away from other investments which are not only more sound to the investor, but also more beneficial to the nation as a whole.

Consider the average investor who is given a choice between investing in a new semi-conductor business in Palo Alto, California or investing in a new semi-conductor business that will be located in an enterprise zone in Brooklyn, New York. Without giving the investor tax incentives, he would likely choose to invest in the Palo Alto business. One reason for this choice might be that an enterprise zone in Brooklyn will be in an area that is known for drugs, gang wars, racial violence, or poverty. Palo Alto does not have such a reputation. Another consideration the investor may have is the education of the labor force. The better educated the labor force, the more likely the business will succeed. Palo Alto, an area known for strong education, likely has a better educated work force. Finally, an investor might consider whether quality engineers are likely to move to Brooklyn over Palo Alto. Most people, particularly professionals, would choose Palo Alto over an enterprise zone in Brooklyn.

Thus, considering all factors, we may assume that an investor, without considering tax incentives, would not choose to invest within the enterprise zone. The factors that an investor would examine in order to determine whether a successful business can be built, point to Palo Alto. But, if we give the investor a chance to defer his capital gain up to \$250,000, or give the investor a chance to take a deduction of up to \$250,000 if he invests in the Brooklyn business, he may invest in the Brooklyn enterprise zone.

Thus, an artificial shift in investment has been implemented through the use of the tax code. The Code encourages the investor to invest not on the basis of which investment brings the best return of capital in its own right, but rather on the basis of a tax savings. The residents of the enterprise zone in Brooklyn are theoretically better off due to the economic development that would not have otherwise taken place. But perhaps this shift in investment is made at a significant cost to the rest of the populace.

If the investment capital was better spent in Palo Alto, the superior locale for a semi-conductor business, then it should receive the investment capital. The artificial shift of capital to the Brooklyn business creates the potential that capital will produce a business that is not as strong, a business that does not produce the best product, and a business, therefore, not as likely to contribute as much to the economic development and growth of the nation as a whole. The possibility a business may operate less efficiently is of particular concern as the nation moves toward a global economy where American products must compete with foreign products.

Yet, America must deal with the real problem of distressed areas, particularly inner cities. Many citizens who live in distressed areas are caught in a cycle of poverty. The areas in which they live are decaying. The plight of the residents of these areas is costly to the nation both through the lost productivity and the cost of funding programs to deal with crime, drug abuse and family disintegration. All citizens ultimately pay for the problems of the few. Aside from the cost, there is the moral issue of showing compassion to people in poverty.

Should we be willing to endure the cost of shifting investment capital away from other investments to inner cities in order to revitalize these areas? Such a question goes to the heart of the enterprise zone debate. It is extremely difficult to answer because the response to a federal enterprise zone program is unpredictable. As explained below, although it is a mistake to think investment alone will solve the problems of these areas, shifting investment into inner cities may be worth the economic cost to the nation. A strong consideration in favor of allowing the investment shift towards designated distressed areas is that enterprise zones mark a change in direction from failed programs in the past. Direct subsidies have not created employment, or any other significant economic activity. Subsidies have not brought an acceptable result for inner cities and are, and will continue to be, costly while failing to provide a long-term solution.

If Congress does enact an enterprise zone proposal, economic development which decreases unemployment and poverty will measure the success of the bill. A successful program will generate new economic activity; new businesses and new employment will be created because of the enterprise zones. Enterprise zones will not be a success if they result in businesses moving from outside the zone to inside the zone to take advantage of the tax and investment incentives.

If an enterprise zone program is adopted, a comparison of the conditions of the zone pre-enactment and post-enactment should be made. Success will have been achieved if there are fewer residents

on welfare, fewer residents on unemployment, and economic revitalization of a once distressed area. The eligibility and selection criteria should be reviewed after the zone has been in existence. There should be a measurable difference in the criteria. A comparison of welfare costs will also indicate whether the program is a success. If zone residents can find employment and become productive, the government should have reduced unemployment benefit and welfare payments.

### C. *Distressed Areas Require More Than Tax Incentives*

Enterprise zones are a valid attempt to deal with a true social and economic problem — the plight of the poor and unemployed populace in distressed areas. But, alone, enterprise zones will not relieve the problems. Tax incentives alone will not bring an economic renaissance to the inner cities, or the poor and unemployed who live there. The belief that if business activity is created, the unemployed will find work and the urban blight will start to disappear is myopic. Tax and investment incentives alone will not revitalize many of the depressed areas of this nation by themselves; any plan must also address complex social problems.

Early in the debate over the success or failure of enterprise zones, a critic of enterprise zones stated:

Significant new economic development, in inner-city neighborhoods or anywhere else, is going to require major *public* investments in physical infrastructure (roads, street lights, bridges, sewers) and services (police, fire, job training, and maintenance of all that infrastructure). The rapid deterioration of these public goods in the older cities . . . has become a serious bottleneck to further private investment in these areas.<sup>258</sup>

The Director of the New York Economic Development Zone Program testified before Congress about the success of New York's program.<sup>259</sup> Tax incentives alone were not the reason she gave for the program's success.<sup>260</sup> The program succeeded because it targeted and provided job training, child care, affordable housing, and education.<sup>261</sup>

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258. Bennet Harrison, *The Politics and Economics of the Urban Enterprise Zone Proposal: A Critique*, 6 INT'L J. URB. & REGIONAL RES. 422, 425 (1982).

259. *Administration's Enterprise Zone Proposal and H.R. 6, The Enterprise Zone Improvements Act of 1989: Hearings Before the House Comm. on Ways and Means*, 101st Cong., 1st Sess. 161, (1989) (statement of Liz Abzug, Director of the N.Y. State Economic Development Zone Program).

260. *Id.*

261. *Id.*

A study of the Illinois enterprise zones found that the most successful enterprise zones were located in areas with adequate infrastructures and public services.<sup>262</sup> The study of the British City of Dudley found that one reason businesses wanted to move into an area was because of the new, clean, energy efficient buildings.<sup>263</sup>

While both congressional proposals realize the importance of state and local governments, business, and the federal government all working together, both may fall short in their attempts to create development relying on tax and investment incentives.

Tax credits and incentives are only part of the construction materials needed to revitalize an area economically. Social problems of the people who make their homes in the economically targeted area will not always respond to economic incentives. Problems with education, crime, drug addiction, and physical facilities within the economic zone must also be relieved in order to break the cycle of economic and social decay. Tax credits and incentives may be a good place to begin, but it is doubtful that they alone will provide a solution to a complex problem.

## V. CONCLUSION

The current enterprise zone legislation warrants thoughtful consideration as a means to cope with a serious national problem. This article has attempted to explain the current proposals, recommend ways to make proposals more effective, and describe the potential effects if enterprise zones become a reality. The unanswered questions remain: Are enterprise zones the best method to help distressed areas? Will tax incentives attract investment? Unfortunately, clear and certain answers to these questions are not available. However, it is clear that the past attempts to improve distressed areas have failed and a new approach is in order.

Clearly, it is a mistake to look at the current legislation for enterprise zones as anything more than a partial solution. It is important to understand that the problems of the inner city are complex and unsolvable simply by tax incentives. Tax and investment incentives will not create a community of skilled workers; they will not stop crime, drug use, or illiteracy. The enterprise zone concept is likely to fail if tax incentives and investment incentives are not interwoven with methods to relieve other social problems.

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262. Ann H. Elder & Ira Cohen, *Evaluation of Effectiveness and Efficiency of Enterprise Zones in Illinois* (June 29, 1989) in U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ENTERPRISE ZONES IN AMERICA: A SELECTED RESOURCE GUIDE 7 (1989).

263. Schwarz & Volgy, *supra* note 227, at 106.

## APPENDIX

### DESIGNATION PROCEDURES

	<i>HR 11</i>	<i>HR 23</i>
<i>Nomination:</i>	Nominated by state and local governments, designation by Sec. of Hud.	Same, except designation made by Sec. of HUD in consultation with other Secretaries.
<i>Number of Designations:</i>	25.	50 and 1/3 must be in rural areas.
<i>Period for Which Designation is in Effect.</i>	25 years, unless revoked because of change of boundaries or non-compliance with course of action.	Same, but not revoked if change in boundaries.
<i>Eligibility Criteria:</i>		
Population.	Population cannot be less than 4000.	Same.
Size.	Area cannot exceed 12 sq. miles, cannot be more than 3 noncontiguous boundaries.	Area must be continuous and must be eligible under § 119 of the Housing and Community Redevelopment Act.
Unemployment.	Not less than 1.5 times the national unemployment rate.	Same.
Poverty Rate.	For not less than 90% of the population census tracts within the EZ is not less than 20%.	Poverty rate for each populous census tract within the EZ is not less than 20%.
Income or Decreasing Population Requirements.	None.	70% of the households in the EZ have income below 80% of the local community under § 119 of the Housing and Community Redevelopment Act; or, the population of the EZ decreased by 20% between 1970 and 1980.
<i>Course of Action:</i>		
a. loans	State and local governments must establish a program for financial institutions to make loans to EZ businesses under the Community Reinvestment Act of 1977. (Mandatory).	No requirement.
b. housing	Special preference to low income housing projects in state housing credit allocations. (Mandatory).	No requirement.

c. private activity bonds.	Special performance in the allocation of private activity bonds to EZ facilities. (Mandatory).	No requirement.
d. taxes.	State and local governments can reduce taxes.	Same.
e. public services.	Increase in efficiency and delivery in public services, streamline regulations and reduce paperwork.	Same.
f. involvement of community groups.	Written commitments to provide job training and technical assistance.	Same, but no written commitments.
g. equity ownership.	None.	Mechanisms to increase equity ownership for residents and employees within the zone.
h. preferences.	Preferences to minority contractors.	None.
i. gifts.	Gifts of surplus land to community groups who will operate zone businesses.	Gifts to help low income and moderate income residents.
j. health insurance.	Establish a program to allow employers to buy health insurance for employees on a pooled basis.	None.
k. linkages.	None.	Linkages to job training, transportation, day care, health care and other social services.
l. local entrepreneurship.	None.	Encouragement of local entrepreneurship.
m. other factors.	None.	Other factors essential to support EZ activities and the quality of life for EZ residents.
n. recognition of past efforts.	Sec. of HUD is to take into account past efforts of the state and local governments in reducing various burdens born by employees and employers.	None.
<i>Selection Criteria:</i>		
State and local contributions.	Selection based in part on the strength and quality of state and local commitments taking into account their fiscal ability.	Same, but also shows preference for tax relief.



## APPENDIX (Continued)

	<i>HR 11</i>	<i>HR 23</i>
Effectiveness of the course of action.	Selection based on effectiveness of promised course of action.	Preference shown for the most effective and enforceable guarantees that the course of action will be carried out.
Private entities commitments.	Selection based on the level of commitments by private entities.	Same.
Ranking.	An average ranking based on unemployment and poverty in the EZ.	None.
Revitalization potential.	Revitalization potential, taking into account the number of jobs to be created and retained.	None.
Other factors:	None.	Factors determined by Secretary of HUD that will have the greatest likelihood of success.

## TAX AND INVESTMENT INCENTIVES

### Employment Credits

	<i>HR 11</i>	<i>HR 23</i>
<i>Employer Credits:</i>	Small employer receives a credit of 10 percent for wages paid to a qualified zone employee.	None.
<i>Employer Credits for Health Insurance:</i>	Employer gets 10 percent credit for health insurance provided to employees.	None.
<i>Employee Credits:</i>	None.	Employee who performs substantially all of his services within an EZ gets a credit up to \$525, but is phased out between \$20,000 and \$25,000.

### Investment Incentives

	<i>HR 11</i>	<i>HR 23</i>
<i>Rehabilitation Credit:</i>	10 percent credit for rehabilitation expenditures if building is 30 years or older.	Left to state and local governments as part of course of action.
<i>Child Care:</i>	Amortizable basis of any child care facility in an EZ over a period of 60 months.	Left to state and local governments to provide as part of course of action.
<i>Investment in Real and Tangible EZ Property:</i>	Deferral of any realized capital gain for up to 9 years if the amount realized from the sale or exchange is reinvested in qualified zone property.	Gain from sale or exchange of capital assets held in an enterprise zone for 2 years is exempt from tax.
a. deferral amount.	Cannot exceed combined \$250,000, including any deferral for qualified EZ equity investment.	N/A.
b. holding period.	Must hold for 5 years.	Must hold for 2 years.
<i>Enterprise Zone Equity Investments:</i>	Deferral of any realized capital gain for up to 9 years if amount realized from the sale or exchange is reinvested in EZ stock or an EZ partnership.	Purchaser of enterprise zone stock allowed deduction of \$50,000 per year.
a. limits on amount.	Cannot exceed combined \$250,000, including any deferral for qualified zone property.	Cannot exceed \$50,000 per year, and \$250,000 in the aggregate.

b. holding period.	5 years.	Same.
c. EZ equity.	C or S corporation or a partnership interest.	C corporation only.
d. Investment.	Ordinary loss for worthless stock or debt in an EZ corporation. Limits on stock issuance by volume cap.	Purchaser reduces basis in stock if deduction is taken. Issuer can issue only \$5 million in stock, and have no more than \$5 million in assets.