DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 12, 1996

CLOSE HOLD

MEMORANDUM FOR GENE SPERLING

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SUBJECT: Tax Initiatives for Urban Revitalization

Summary

At the request of the NEC, we prepared the attached descriptions of tax initiatives that are intended to encourage urban revitalization and wage credits for economically disadvantaged persons. Four types of tax initiatives are discussed: incentives for equity investment in CDFIs; employment promotion initiatives through wage credits; expansion of the earned income tax credit to offset reductions in food stamp benefits; and capital promotion incentives through targeted capital gains relief.

We briefly described the wage credit options and the EITC option at last Friday's NEC meeting. At your request, we are also developing an enhanced work opportunity tax credit option. Assuming you schedule another NEC meeting later this week, we can present all of the options to the NEC at that time. We are providing the descriptions to you now for your information; please do not circulate them.

Discussion

The attachment describes the following tax initiatives and their advantages and disadvantages:

A. CDFI initiatives

Tax credits would be provided for equity investments in CDFIs:
1. $100 million capped credit. Revenue loss FY 1997-2002: $91 million.
2. $300 million capped credit. Revenue loss FY 1997-2002: $271 million.
3. Uncapped credit. Preliminary revenue loss FY 1997-2002: $316 million.

B. Employment promotion

(a) EZ/EC wage credit (20% of wages up to $15,000) would be provided to employers who hire:
1. Employees who live and work in the 95 first-round ECs. Revenue loss FY 1997-2002: $9.5 billion.
2. Employees who live and work in the 20 second-round EZs. Revenue loss FY 1997-2002: $3.5 billion.
3. Eliminate the tax-liability limitations for the empowerment zone wage credit. Revenue loss FY 1997-2002: $262 million.

(b) Work opportunity tax credit (35% of wages up to $6,000) would be provided to employers that hire members of certain targeted groups:

1. Permanent credit. Revenue loss FY 1997-2002: $2.0 billion.
2. Extend to EZ residents 25 years old or older. Revenue loss FY 1997-2002: $180 million.
3. Extend to EZ and EC residents 25 years old or older. Revenue loss FY 1997-2002: $1.6 billion.
4. Provide eligibility for members of families who are no longer eligible for family assistance because of the 5-year limit under welfare reform. Revenue loss occurs outside the FY 1997-2002 period.
5. Provide eligibility for certain childless adults who are no longer eligible for food stamps because they failed to meet minimum work requirements under welfare reform. Preliminary revenue loss FY 1997-2002: $386 million.

C. <u>Earned Income Tax Credit</u>

EITC phase-in rate would be increased by three to four percentage points. Preliminary revenue loss FY 1997 - 2002: $15 billion to $18 billion.

D. <u>Capital promotion</u>

(a) Capital gains exclusion (50%) for gains on the sale of qualified assets held for 5 or more years for empowerment zone (EZ) and enterprise community (EC) assets. Revenue loss FY 1997-02: $85 million.

(b) Capital gains exclusion (50%) for gains on the sale of qualified investments in small CDFIs held for 5 years or more. Revenue loss FY 1997-02: $14 million.

EXPANSION OF THE EMPOWERMENT ZONE WAGE CREDIT

Current Law

An employer may claim a 20-percent empowerment zone wage credit based on qualified wages paid to an employee who both lives and works in one of the 9 federal empowerment zones designated on December 21, 1994. The maximum amount of qualified wages is $15,000, so that the maximum credit is $3,000. Beginning in 2002, the rate of the credit is reduced 5 percent per year through 2004. No credit is allowed after 2004. Unlike the work opportunity tax credit (WOTC), the empowerment zone wage credit is not limited to wages paid during an employee's first year of employment.

The empowerment zone wage credit may not be claimed with respect to certain employees (e.g., relatives of the owners of the employer) or by businesses engaged in certain activities (e.g., liquor stores and large farms). A self-employed individual may not claim the credit with respect to his or her own earnings, but may claim it with respect to amounts paid to qualified employees.

The empowerment zone employment credit is claimed by an employer as part of the general business credit. As such, the credit that can be claimed in any taxable year is limited to 25 percent of the taxpayer's net regular tax liability that exceeds $25,000. A limitation also applies with respect to the amount of an employer's alternative minimum tax liability that may be offset by the empowerment zone employment credit. Credits that are not claimed currently because of these tax-liability limitations may be carried back 3 years (but not to a year prior to 1994) and carried forward 15 years, subject to the tax-liability limitations applicable in those years. This tax-liability limitation is intended to minimize fairness concerns that have arisen in the past relating to businesses that zero out their federal income tax liabilities.

The empowerment zone employment credit is not available to employers in the 95 enterprise communities designated on December 31, 1994. Because employer tax returns for 1995 (the first full year in which the credit was available) are still being filed and processed, we have no information regarding the extent to which employers are claiming the credit.

As part of the President's FY1997 budget, a second round of empowerment zone and enterprise community designations have been proposed. Twenty new empowerment zones would be designated (15 in urban areas and 5 in rural areas). The empowerment zone employment credit would not be available to businesses in the 20 second-round empowerment zones.

Reasons for change

The Administration believes that special consideration should be given to the problems of distressed areas. Revitalization of economically distressed areas through expanded employment incentives, especially for residents of those distressed areas, should help alleviate economic and social problems. In particular, tax incentives for employers in the form of wage subsidies will increase the employment opportunities for zone residents. The Administration also believes that a federal tax incentives for distressed areas should be focused in empowerment zones, where State and local governments have also committed resources in the locally developed strategic plans for economic revitalization.

Proposal

Option 1: Extend the empowerment zone wage credit to employers with employees who live and work in the 95 first-round enterprise communities.

Option 2: Extend the empowerment zone wage credit to employers with employees who live and work in the 20 second-round empowerment zones.

Option 3: Make the tax-liability limitations inapplicable to the empowerment zone wage credit, so that the credit may offset the full amount of any positive income tax liability.

Revenue Estimate

The revenue loss for FY 1997-2002:

Option 1: $9.5 billion.
Option 2. $3.5 billion.
Option 3. $262 million.

Pros

- A location-based incentive would avoid the stigma reportedly associated with the targeted groups eligible under the prior law targeted jobs tax credit.
- The proposal is an extension of the Administration's empowerment zone program.
- The proposal would reduce employers' cost of labor with respect to residents of empowerment zones, thereby increasing employment opportunities for workers who live in distressed areas. It would thereby reinforce the distinction between the Clinton Administration's emphasis on labor incentives and the prior Republican enterprise zone proposals that emphasized capital incentives.
- The elimination of the tax-liability limitation would substantially increase the benefit of the credit to small and start-up businesses.

Cons

- The effectiveness and efficiency of the empowerment zone wage credit is uncertain, such that any extension may be premature at this time.
- Limiting the expansion of the credit to already designated enterprise communities or second-round empowerment zones limits the political attractiveness of these options.
- Limiting any tax incentive to employees who live and work in relatively small, geographically discrete areas (such as census-tract based empowerment zones and enterprise communities) raise compliance issues.
- Removing the tax-liability limitations may result in perception problems, especially to the extent medium-sized and large businesses are able to zero out their liabilities (which may be attributable primarily to activities outside of the zones).

WORK OPPORTUNITY TAX CREDIT

Current Law

The Small Business Job Protection Act of 1996 provides a work opportunity tax credit (WOTC) for hiring individuals from certain targeted groups. The credit would equal 35 percent of qualified wages paid during the first year of employment with the employer up to $6,000. The maximum credit would be $2,100. The credit is effective October 1, 1996 and expires after one year (September 30, 1997).

The targeted groups are the following: (1) Members of families receiving assistance (AFDC or successor program) for a period of at least 9 months part of which is during the 9-month period ending on the hiring date; (2) Qualified ex-felon who is a member of a family during the six months before the earlier of the date of determination or the hiring date which on an annual basis is 70 percent or less of the BLS lower living standard; (3) High-risk youth 18-24 years old who reside in an empowerment zone (EZ) or enterprise community (EC); (4) Vocational rehabilitation referral; (5) Qualified summer youth employee 16 or 17 years old who reside in an EZ or EC; (6) Qualified veteran who is a member of a family receiving AFDC for a 9-month period, part of which is during the 12-month period ending on the hiring date, or a food stamp program for at least three months part of which is during the 12-month period ending on the hiring date; (7) Qualified food stamp recipient who is 18 to 24 years old and a member of a family receiving food stamps for a period of at least six months ending on the hiring date, or, in the case of certain individuals without dependents that cease to be eligible because the minimum work requirement under welfare reform has not been met, receiving such assistance for at least 3 months of the 5-month period ending on the hiring date.

Under current law, an employer may claim a 20 percent empowerment zone (EZ) wage credit for qualified wages paid to an employee who lives and works in an EZ. The maximum amount of qualified wages for each employee is $15,000 per year, so that the maximum credit is $3,000 per year. Beginning in 2002, the rate of the credit is reduced 5 percentage points per year. No credit is allowed after 2004.

Reasons for Change

A temporary wage credit does not provide employers a continuing incentive to hire economically disadvantaged individuals. Expanding the eligible groups under the work opportunity tax credit will encourage employers to hire persons who reside in economically distressed areas, persons who are no longer eligible for family assistance (because of the 5 year limit on benefits) and food stamps (because of the minimum work requirements).

Proposal

Option 1: Make the WOTC permanent;

Option 2:	Include residents of EZs 25 years old and older;
Option 3:	Include residents of EZs and ECs 25 years old and older;
Option 4:	Provide a two-year period of eligibility for the WOTC for recipients of family assistance who are no longer eligible for that assistance because they reached the 5-year limit under the welfare reform bill;
Option 5:	Include as an eligible food stamp recipient under the WOTC childless adults 25 through 50 who are no longer eligible for food stamps because they did not meet the minimum work requirements under the welfare reform bill.

Revenue Estimate

The revenue loss for FY 1997 - 2002:

Option 1:	$2.0 billion
Option 2	$180 million
Option 3:	$1.6 billion
Option 4:	Revenue loss occurs outside this period.
Option 5:	$386 million

Pros:

- A permanent WOTC would provide employers with an incentive to hire members of economically disadvantaged target groups. It recognizes the continuing need for employment opportunities for these individuals.
- The proposal would reinforce the Administration's commitment to addressing the problems of economically distressed areas by reinstating the labor incentives contained in its 1993 EZ proposal in the context of the work opportunity tax credit.
- The proposal would improve employment opportunities for persons who need to move from welfare to work because they are no longer eligible for family assistance and food stamps.

Cons:

- The WOTC, like the targeted jobs tax credit (TJTC) that it replaced, would probably largely be a windfall to employers who would have hired members of the target groups even absent the credit. It may not improve the type of jobs held by WOTC recipients or their earnings after WOTC employment. (These are the findings of the Department of Labor's Inspector General, the General Accounting office and other studies of the TJTC).
- Expanding eligibility to EZ/EC residents does not adequately target the truly

disadvantaged and would expand the opportunity for abuse by claiming credits for hiring EZ/EC residents who are not economically disadvantaged. For example, EZ residents would include students at major universities (such as Columbia University) who are not economically disadvantaged youth.

EXPAND EARNED INCOME TAX CREDIT

Current Law

Low-income workers may be eligible for the refundable earned income tax credit (EITC). The amount of the EITC depends on whether the worker has one, more than one, or no children. The credit initially increases with earned income, then remains constant as earned income rise, and finally decreases with adjusted gross income (or earned income, if greater) until it is fully phased out.

The parameters of the credit depend on the number of qualifying children claimed by the taxpayer. For 1996, the parameters are as follows:

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate	40%	34%	7.65%
Earnings at which maximum credit reached	$8,890	$6,330	$4,220
Maximum credit $323	$3,556	$2,152	
Phaseout begins	$11,610	$11,610	$5,280
Phaseout rate	21.06%	15.98%	7.65%

Reason for Change

In 1993, the President set a goal that a four-person family, headed by a minimum wage worker, should not live in poverty. Recently enacted reductions in the food stamp program will make this goal difficult to achieve, unless the EITC is further expanded.

Option

To offset the reductions in the food stamp program among minimum wage workers with one or more children, the EITC phase-in rate would be increased by between three to four percentage points (about a $300 increase in the maximum amount of the credit in the year 2002).

Revenue Estimate

A proposal to offset the effects of food stamp reductions among working low-income families could be designed at an annual cost of between $3 to $4 billion.

Pros

- Using the EITC to offset the food stamp reductions would provide direct assistance to low-income working families. Among likely tax options, the EITC is the most effective way to increase the take-home pay of low-wage workers.
- A carefully-designed EITC expansion could also further improve work incentives among low-income parents, particularly among those outside the workforce.
- An expansion of the EITC would help close the poverty gap for minimum wage workers with families.

Cons

- Citing concerns with continuing non-compliance among EITC claimants, Congressional opponents of the EITC could respond to a proposed expansion with a counter proposal to reduce the credit. The FY 1997 budget resolution still assumes congressional action on a proposal to reduce the EITC by $18 billion over the next six years.
- An EITC expansion would not spur job creation in the cities -- a high priority of the White House urban initiative working group.
- The food stamp reductions affect all low-income families, including both workers and non-workers. Increasing the EITC will not offset the losses suffered by those truly unable to work, such as families headed by disabled individuals.
    - Within the confines of the current EITC structure (a credit which initially increases with earned income), it may also be difficult to compensate some very low-wage workers fully for their food stamp benefit losses. Other families may be overly compensated by an EITC expansion, because the EITC extends to families with higher income than the food stamp eligibility cut-offs.

CAPITAL GAIN EXCLUSION FOR ECONOMICALLY DISTRESSED AREAS

Current Law

Capital gains income receives preferential treatment relative to other forms of income. For example, unlike other types of income, the maximum tax rate is 28 percent and tax is deferred on gains until realized. Accrued gains on assets held at death are never taxed because the basis is stepped-up to the market value at the date of death. In addition, 50 percent of capital gains on new equity investments in certain small businesses (less than $50 million in assets) are excluded from income provided certain conditions are met. In particular, the stock must be held for at least 5 years and the gain eligible for exclusion cannot exceed $10 million or ten times basis per issuer. This special capital gains treatment is not available for most other investments.

Reasons for Change

Excluding capital gains on investment in distressed areas will encourage investment and stimulate revitalization of these areas.

Proposal

The proposal extends the present small business exclusion to certain investments in Empowerment Zones (EZs) and Enterprise Communities (ECs) with the following modifications: it would eliminate the $50 million cap on assets for determining the size of eligible businesses and would extend the exclusion to certain tangible property and certain partnership interests.

For both EZs and ECs, 50 percent of qualified capital gains recognized on the sale or exchange of a qualified zone asset held for 5 or more years would be excluded from income. Qualified assets include originally issued stock in qualifying zone businesses, tangible business property with original use or substantially improved within the zone, and partnership interests acquired for cash. Only the gain attributed to the period when the zone is designated and the business qualifies would be eligible for the 50 percent exclusion. This effectively acts as a sunset provision, as current designations lapse in 2004.

As with the tax incentives included in the OBRA '93 EZ and EC legislation and the current-law small business 50-percent exclusion, there are also restrictions on the types of businesses and assets that can qualify for this proposed capital gains exclusion. For example, businesses that develop and hold intangible assets for sale or license or rent residential property would not eligible for the capital gains relief. Similarly, gain from the sale of land is not eligible for the exclusion unless the land is an integral part of a business being sold. Finally, the gain eligible for exclusion cannot exceed $10 million or ten times basis per business.

Revenue Estimate

The revenue loss for FY 1997-2002: $85 million

Pros

- The 5-year holding period postpones the larger revenue losses to the second 5-year period, typically outside the budget window.

- The restrictions on the types of businesses and investment eligible for the capital gains exclusion lowers the revenue loss from the proposal.

- The sunset provision encourages acceleration of investment and provides an automatic end to the program.

Cons

- Primary beneficiaries of capital gains relief are existing owners of capital who are unlikely to live in the targeted areas.

- The capital gains exclusion may result in few jobs being created in the targeted areas if much of the new investment is in property used in capital intensive activities, such as warehouses, telephone switching equipment and similar businesses.

- A capital gains exclusion is a "backloaded" capital incentive that does little to increase the liquidity of struggling new businesses.

- This proposal is similar to capital exclusion provisions included in the former Republican Administration's Enterprise Zone proposals and specifically excluded from the Clinton Administration's 1993 Empowerment Zone and Enterprise Community proposals.

- Since many of the Republicans have a strong desire for an across the board capital gains tax cut, any Administration proposal for a targeted urban capital gains cut could become an add-on provision with an even more generous exclusion for the targeted investments.

CAPITAL GAINS RELIEF FOR CONTRIBUTIONS TO CDFIs

Current Law

The Community Development Banking and Financial Institutions Act of 1994 created a federal CDFI fund to provide grants, loans, and technical assistance to qualifying lenders. After being reduced in 1995, the CDFI fund has $50 million in assistance to provide to the various CDFI qualified institutions. CDFIs are financial institutions that have community development as their primary mission and that develop a range of programs and methods to carry out that mission. Currently, CDFIs and their investors are not eligible for special tax incentives, including the 50-percent exclusion for certain capital gains (which is not applicable to any banking, financing, investing, or similar business).

Reasons for Change

The Administration believes that extending tax incentives to encourage investment in CDFIs will leverage additional private investment in distressed areas and stimulate the economic revitalization of those areas.

Proposal

50 percent of capital gains earned on investments in small, qualified CDFIs would be excluded from income. Small CDFIs would generally be those with $50 million or less in assets. Investments would have to be held for 5 years in order to qualify.

Revenue Estimate

The revenue loss would be $14 million between FY 1997 and 2002. Most of the revenue loss occurs outside the budget window since investments must be held for 5 years in order to qualify.

Pros

- Most of the revenue loss occurs outside the budget window since investments must be held for 5 years in order to qualify.

Cons

- Capital gains relief should be resisted since the revenue loss is likely to be great, particularly in comparison to the benefits reaped by the distressed community.
- Capital gains cuts are unlikely to benefit residents in the targeted areas directly since the primary beneficiaries are the owners of capital who are unlikely to live in the targeted areas.

- The Administration rejected targeted capital gains proposals in the first and second round of the Empowerment Zone initiative. Moreover, since Republicans have a strong desire for an across the board capital gains tax cut, any Administration proposal for targeted capital gains relief could become an add-on provision with an even more generous exclusion for targeted investments.

- This proposal does not assist large CDFIs, non-profit CDFIs or those that do not issue stock, such as mutual organizations.