United States General Accounting Office

GAO

Report to Congressional Requesters

June 1998

COMMUNITY DEVELOPMENT

Information on the Use of Empowerment Zone and Enterprise Community Tax Incentives

GAO/RCED-98-203

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-279566

June 30, 1998

The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives

The Honorable Nancy Johnson
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The Honorable Christopher Shays
Chairman, Subcommittee on Human Resources
Committee on Government Reform and Oversight
House of Representatives

The Empowerment Zone and Enterprise Community (EZ/EC) program is designed to help revitalize urban and rural communities. This 10-year federal effort was enacted as part of the Omnibus Budget Reconciliation Act of 1993 as a comprehensive approach to addressing the problems of distressed communities. The program targets federal grants for social services and community redevelopment and provides three tax incentives to attract or retain businesses in distressed areas. These tax incentives include tax-exempt private activity enterprise zone facility bonds that make financing available to qualified EZ and EC businesses at lower rates than conventional financing; an employment and training credit, called the EZ employment credit; and a $20,000 increase in the expensing allowance for the depreciable business property of qualified EZ businesses.

During an October 1997 hearing on the EZ/EC program, questions arose about how well these initiatives are working and whether the current law provides the right mix of tax incentives. To help answer these questions, you asked us to examine the extent to which data exist to determine how the tax incentives have been used. To make this determination, we examined the availability of data from the Internal Revenue Service (IRS) on each of the three tax incentives, as well as data from state officials on the use of the tax-exempt enterprise zone facility bonds.

Results in Brief

Reliable data for only one of the three tax incentives are currently available from IRS—the agency to which taxpayers report their use of the tax incentives. Specifically, IRS has reliable information on businesses' use of tax-exempt enterprise zone facility bonds during 1995, which we corroborated and updated through a survey of officials in the District of Columbia and the 43 states that contain empowerment zones and enterprise communities. IRS' data indicate, and our survey confirmed, that three tax-exempt enterprise zone facility bonds were issued in 1995, and the state officials we surveyed reported that five other such bonds were issued in the next 3 years—one in 1996, two in 1997, and two in 1998. The eight bonds totaled $17.7 million. IRS has not yet completed its computer processing and analysis of the original returns for bonds issued in 1996 and 1997. Because IRS' information on businesses' use of the other two tax incentives—the employment credit and the additional $20,000 expensing allowance for depreciable business property—is not reliable, according to Treasury and IRS officials, we were not able to determine how often these incentives were used. For both incentives, the number of businesses and business owners that were included in IRS' samples for tax years 1994 through 1996 and that reported using these incentives was too small to project reliably to all empowerment zone businesses and owners that filed tax returns. As a result, IRS started collecting data from all businesses and owners on their use of the empowerment zone employment credit, but problems with the quality of the corporation data for tax years 1994 through 1996 prevent the use of these data. IRS plans to issue a directive to its responsible executives and managers on problems with the employment credit data and on steps to take in addressing these problems. IRS also plans to conduct special studies of the credit using returns already filed. It does not, however, plan to make any changes in the way it collects information on the additional expensing allowance for depreciable business property because the tax forms on which the expensing is claimed are not computerized and the tax incentive is considered small.

Background

The Omnibus Budget Reconciliation Act of 1993 established the EZ/EC program as a comprehensive approach to help designated communities revitalize deteriorating areas. The guidelines for implementing the program describe it as one in which solutions to communities' problems are to originate from the neighborhood up rather than from Washington, D.C., down. Business tax incentives, together with other provisions, such as federal grants for community redevelopment and social services,[1] were intended to revitalize the distressed areas.

[1]Federal grant funding came from amending title XX of the Social Security Act to authorize the special use of Social Services Block Grant funds for the EZ/EC program. The allotted funds are granted by the Department of Health and Human Services to the state, which is fiscally responsible for the funds.

In December 1994, 9 EZs and 95 ECs were designated in the first round of this program. The Taxpayer Relief Act of 1997 provided a second round of the program and authorized the designation of up to 22 additional EZs—2 additional first-round EZs and up to 20 second-round EZs. Parts of Cleveland, Ohio, and Los Angeles, California, have been designated by the Department of Housing and Urban Development as the two additional first-round EZs, to be effective on January 1, 2000. The remaining 20 second-round EZs are to be designated by January 1, 1999, by the Department of Housing and Urban Development and the Department of Agriculture.[2]

The Omnibus Budget Reconciliation Act of 1993 established three tax incentives that are designed to lower the cost of doing business in an EZ or EC: (1) a tax-exempt enterprise zone facility bond, (2) an employment credit, and (3) an increase of $20,000 in the expensing allowance for depreciable business property authorized under section 179 of the Internal Revenue Code. While both EZs and ECs can use the tax-exempt facility bond incentive, the two remaining tax incentives are available for use only in the EZs. For the first 5 years of the EZ/EC program, the dollar value of these tax incentives was estimated to be $2.5 billion.

Enterprise zone facility bonds were authorized for the EZ/EC program as a new category of tax-exempt private activity bonds offering lower rates to businesses than conventional financing. These bonds can be used by EZ/EC businesses to finance business property and land, as well as to finance new facilities or the expansion or renovation of existing facilities. However, like most private activity bonds, they are subject to an annual private activity bond volume cap that is established for each state.[3] Additionally, the aggregate face amount of these bonds for each qualified EZ/EC business may not exceed $3 million per EZ or EC and $20 million for the same business in all zones nationwide. The authorizing legislation requires each business that benefits from these bonds to ensure that at least 35 percent of its employees are residents of an EZ or EC, as well as to comply with other financing rules.

[2]The Taxpayer Relief Act of 1997 also designated parts of the District of Columbia as an enterprise zone eligible for many of the same tax incentives as the EZs.

[3]Under current law, each state has the authority to issue tax-exempt private activity bonds in an amount equal to $50 per resident. If a state's population results in the authority to issue less than $150 million, the state's allocation is automatically raised to $150 million.

The EZ employment credit is a credit for up to 20 percent[4] of the first $15,000 in wages paid to a resident of the zone who also works in the zone. This is a maximum tax credit of $3,000 per year for each employee who lives in the EZ and works for an EZ business.

Section 179 of the Internal Revenue Code allows businesses to recover the cost of certain depreciable property, such as equipment and machinery, by deducting all or part of the cost in the year that the property is placed in service rather than over several years. For qualified EZ businesses, however, the limit is $20,000 above that set for other businesses, currently $18,500 per year.[5] This additional $20,000 expensing deduction can be used for all qualifying EZ property and lowers capital costs for EZ businesses by allowing them to deduct the cost of an asset in the year it is purchased, up to the limit for that year.

Individuals and businesses use three different forms to report data to IRS on their use of the three tax incentives. Enterprise zone facility bonds are reported only once, within about 45 days after the quarter in which they are issued, on Form 8038—Information Return for Tax-Exempt Private Activity Bond Issues—by the state or local governmental unit that issues the bonds. An individual or business uses Form 8844—Empowerment Zone Employment Credit—to claim the 20-percent wage credit and uses Form 4562—Depreciation and Amortization—to claim the additional expensing allowance. Both of these forms are filed with the regular tax returns each year.

IRS has two principal sources of tax data that it uses for analysis. The first is an electronic master file system, which includes a business master file and an individual master file, each of which contains selected line-item data reported on IRS tax forms from businesses and individuals. The second is a set of data files based on a sample of tax returns maintained by IRS' Statistics of Income (SOI) Division.[6] IRS maintains selected information on the EZ/EC program's tax incentives in its business and individual master files and in the SOI samples for tax years 1994 through 1996.

[4]The credit will be reduced by 5 percentage points per year starting in 2002 for the nine initial EZs and in 2005 for the two EZs that were designated in January 1998.

[5]The limit for this deduction—which was $17,500 until 1997—will be raised in annual increments until it reaches $25,000 for the years after 2002.

[6]SOI designs and draws statistical samples of tax returns, extracts and edits data from the returns, weights the data to represent the universe of sampled returns, and provides these data in tabular and other forms with supporting material to users inside and outside the federal government. SOI's data are used primarily to analyze federal tax policy.

Reliable Data Are Currently Available for Only One of the Three EZ/EC Tax Incentives

We obtained information on the use of tax-exempt facility bonds from IRS, as well as from officials responsible for keeping track of such bonds in the District of Columbia and the states. However, no reliable data are currently available on EZ businesses' use of the employment credit or the additional expensing allowance for depreciable business property.

Eight Tax-Exempt Facility Bonds Have Been Issued

Enterprise zone facility bonds have been used eight times since 1995. IRS' data show that three enterprise zone facility bonds totaling $7.2 million were issued in 1995.[7] Our survey of officials from the District of Columbia and all 43 states with EZs or ECs confirmed IRS' data for 1995 and showed that five other enterprise zone facility bonds have been issued—one in 1996, two in 1997, and two in 1998.[8] These eight bonds, totaling $17.7 million, ranged from $1.2 million to $3.0 million and were for a variety of projects, including a convention hotel project, a uniform rental project, and a residential finance project. In addition, since 1995, four states each received an application for an enterprise zone facility bond that was either not approved or was approved but not issued. Table 1 provides more information on the bonds that were issued.

[7]At this time, IRS has data on enterprise zone facility bonds from 1995—the first full year after the EZs and ECs were designated. IRS has not yet completed its computer processing and analysis of the original information in returns for bonds issued in 1996 and 1997. IRS officials expected the 1996 bond data to be processed in the summer of 1998 and the 1997 bond data to be available in the spring of 1999.

[8]Although our survey did not ask why these bonds were not used more extensively, three respondents said that the requirements were so restrictive that companies were discouraged from using the bonds.

Table 1: Enterprise Zone Facility Bond Issues

Dollars in millions

Date of issue	Location	Amount	Name of issuing authority and/or project
Aug. 9, 1995	Detroit, MI	$3.0	Michigan Strategic Fund—Mechanics Uniform Rental Project
Nov. 20, 1995	Waco, TX	$3.0	Central Waco Development Corporation—Central Texas Convention Hotels 1 Project
Dec. 21, 1995	Cordele, GA	$1.2	Crisp County Cordele Industrial Development Authority—Florida Seed Company
Sept. 19, 1996	San Diego, CA	$3.0	California Statewide Communities Development Authority—JTF Enterprises/Figi Graphics
Mar. 21, 1997	Albany, GA	$3.0	Albany/Dougherty County Payroll Development Authority—Flint River Services, Inc.
June 19, 1997	Rosedale, MS	$1.9	Jimmy Sanders, Inc.
Jan. 29, 1998	Atlanta, GA	$1.4	Urban Residential Finance Authority—Black Bear Apartments
Apr. 9, 1998	Wilmington, DE	$1.2	City of Wilmington—Loans to Lenders program

Source: GAO's survey of state officials who track state volume caps for private activity bond issues.

EZ Employment Tax Credit Data Are Not Yet Available From IRS

According to Treasury and IRS officials, data from sampled returns of qualified EZ businesses on their use of the employment tax credit during tax years 1994, 1995, and 1996 are not reliable.[9] For example, SOI officials said that the number of returns in their samples (for corporations and individuals) for tax year 1996 that included an Empowerment Zone Employment Credit Form 8844 was too small for a reliable estimate of the use of this tax incentive. They noted that the samples are not drawn to project business activity in the EZs. Specifically, the preliminary data sample of about 90,000 returns from corporations included only 100 returns with a Form 8844, while the sample of about 115,000 individual returns (some business owners may also claim this credit) included only 28 returns with a Form 8844. In addition, according to information in IRS' business master file, in processing year 1997 only 340 corporations claimed the EZ wage credit out of about 5 million corporations. When IRS officials compared the EZ wage credit data from these 340 returns with the data from the 100 returns in their preliminary corporate sample, they

[9]Each of SOI's annual samples of corporations covers returns with accounting periods ending between July 1 and June 30. For example, SOI's sampling for tax year 1996 covers corporations whose accounting period ended between July 1, 1996, and June 30, 1997. However, the information entered into IRS' master file system uses a different time frame, called a processing year. This processing year follows the year for which the tax returns were filed. For example, processing year 1996 is for tax returns filed for 1995. Corporate returns will be part of the processing year in which they are received.

found inconsistencies between the two sets of data, raising questions about the reliability of the data.[10]

IRS officials told us about possible reasons for these inconsistencies. For example, they said that the corporate tax returns that could include a Form 8844 are not checked as extensively for consistency during IRS' processing as the individual returns that include the form; therefore, the data on the EZ wage tax credit entered from individual returns into the individual master file are considered more accurate than the data entered from corporate returns into the business master file. Specifically, they said that the tax data reported for the EZ employment credit on an individual tax return are checked for consistency with the data reported for the other credits listed on the same form, while the data reported on a corporate return do not undergo such a check. Treasury officials also pointed out that the IRS staff who code and edit data could overlook the Form 8844 when they enter data from large corporate tax returns.

IRS officials also told us that the agency will soon issue a management control directive to alert responsible IRS executives and managers to problems associated with the EZ employment tax credit data in the business master file and to indicate what steps managers should take to address these problems. Problems identified in the directive include the omission of EZ tax credit data, reported on original returns, from the business master file; and the incorrect entry of data from the original returns into the business master file. In addition, the EZ tax credit amounts were inconsistently entered into the business master file from the tax returns, preventing the master file from being useful as a source of data for the corporate population. In response to this situation, the proposed control directive calls on IRS executives and managers to improve the quality of the data by regularly monitoring the master file's products and conducting follow-up training at IRS service centers as needed. Managers are also to ensure that the instructions for processing the EZ employment credit are clear and consistent.

Other actions to improve the data available on the EZ employment credit include the following:

- To better analyze the recent and upcoming use of the EZ wage tax credit, SOI started a master list of all corporations with returns in the business master file or in the SOI files that claimed this credit in processing years

[10]A similar comparison of the processing year 1997 EZ wage credit data from the 1,128 returns in the master file for individuals with the 28 returns in the sample for individuals found relatively few inconsistencies.

1995 through 1998. SOI will add the corporations with tax returns processed in 1999 and use the resulting list to analyze returns from these potential users of the EZ credit. Using actual tax returns will allow SOI to analyze the use of this EZ wage tax credit and to verify the accuracy of the data in SOI's master lists.

- In February 1998, SOI requested the processing year 1997 corporate returns for the 340 businesses that, according to the business master file, claimed the EZ wage tax credit. As of May 1998, SOI had received 245 of these returns, which the division was reviewing to evaluate, among other things, the accuracy of the business master file's data for the EZ wage tax credit, as well as to provide data on the credit's use.
- Beginning in January 1999, the business master file will include additional data that will facilitate the identification of corporate returns that include the Form 8844.

IRS Does Not Have Reliable Data on the Additional Expensing Allowance

IRS officials reported that none of the information on expensing and depreciation that businesses or individuals file on Form 4562 (Depreciation and Amortization) is computerized and entered into a master file. Therefore, IRS' master files do not indicate which or how many returns include a Form 4562. When SOI samples tax returns and examines the originals, it identifies those that include a Form 4562. However, according to SOI, the information from such sampling is not reliable for estimating the use of this tax incentive because the tax incentive occurs infrequently and the sample is not drawn in order to project information for businesses in the EZs.

In a review of SOI's corporate sample for tax year 1996, IRS identified 124 returns with expensing deductions large enough to indicate that they might be eligible for the additional EZ expensing allowance. According to an IRS official, a further review indicated that almost none were, in fact, eligible because of errors in taxpayers' calculation and reporting of the additional EZ expensing allowance. Treasury found similar results for the tax year 1995 individual returns, identifying only six returns that claimed the additional EZ expensing allowance. However, a closer review of these returns indicated that they did not appear to claim the additional allowance. IRS officials considered these results too small to project reliably to all EZs. IRS officials added that it was not feasible for them to identify all of the returns claiming the additional expensing allowance because data from Form 4562 are not entered into the master file and a manual review of all tax returns is not possible. IRS does not plan to make any changes to its operations to improve its identification of returns claiming the EZ expensing benefits.

Agency Comments

We provided copies of a draft of this report to IRS and the Department of the Treasury for their review and comment. We received comments from both agencies, including comments from the Chief of the Corporation Research Section in IRS' Statistics of Income Division and the Director of Treasury's Office of Tax Analysis. They generally agreed with the information presented in the report but provided a number of technical corrections, such as suggesting the use of the term "expensing" to distinguish the additional section 179 expensing deduction provided to EZs from other types of deductions for depreciation. We have incorporated their comments where appropriate.

Scope and Methodology

To determine the extent to which the three EZ/EC tax incentives have been used, we interviewed IRS officials responsible for analyzing tax data and Treasury officials involved in studying and analyzing EZ/EC tax information. We reviewed the tax forms and instructions used to report data for these tax incentives, as well as preliminary data from IRS on the EZ employment tax credit. We reviewed other relevant reports and documents, such as related GAO reports and testimonies; agencies' publications, studies, and materials; enabling congressional legislation with accompanying reports and testimony; and articles from the private sector on these tax incentives.

To obtain more recent data on the extent to which qualified enterprise zone facility bonds have been issued, we surveyed officials responsible for keeping track of the private activity bond volume caps in the District of Columbia and in each state that contains at least one EZ or EC. We compared IRS' 1995 data on enterprise zone facility bonds with the states' data, and the information was the same. We performed our work in accordance with generally accepted government auditing standards from October 1997 through May 1998.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days after the date of this letter. At that time, we will send copies to the appropriate congressional committees, the Secretary of the Treasury, and the Commissioner of Internal Revenue. Copies will be made available to others upon request.

Please call me at 202-512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix I.

Stanley J. Czerwinski
Associate Director, Housing and
Community Development Issues

Major Contributors to This Report

Nancy Boardman
Bess Eisenstadt
Kim Hutchens
Joan Mahagan
John McGrail
Pat McGuire
Hattie Poole
Nancy Simmons
Jim Wozny

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (202) 512-6061, or TDD (202) 512-2537.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

For information on how to access GAO reports on the INTERNET, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

http://www.gao.gov

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use $300

Address Correction Requested