

“IN THE ZONE”

**SPECIAL FINANCING AND INCENTIVES FOR
ENTERPRISE ZONES AND ENTERPRISE AND
RENEWAL COMMUNITIES**

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INTRODUCTION

This paper relates to federally designated areas called “empowerment zones,” “enterprise communities,” and “renewal communities” with particular emphasis on federally tax-exempt bond financing that may be available for qualifying projects located in empowerment zones and enterprise communities (but not renewal communities unless they are also empowerment zones or enterprise communities).

Such areas should not be confused with “enterprise zones” created under Georgia law, either by local act of the General Assembly or pursuant to the provisions of the Enterprise Zone Employment Act of 1997, which added a new Chapter 88 to Title 36 of the Official Code of Georgia, and amendments thereto.

However, if a business is located in an area that is both a Georgia “enterprise zone” and a federally designated “empowerment zone,” “enterprise community,” or “renewal community,” it may be eligible for both federal and state incentives.

FEDERAL EMPOWERMENT ZONES AND ENTERPRISE COMMUNITIES

The Omnibus Budget Reconciliation Act of 1993 authorized the creation by the “appropriate secretary” (the Secretary of HUD in urban areas and the Secretary of Agriculture in rural areas) of 9 “empowerment zones” (six in urban areas and three in rural areas) and 95 “enterprise communities” (collectively generally called “Round One Zones”). As used herein the term “zone” includes both empowerment zones and enterprise communities. One Round One Zone, an empowerment zone, is located in Atlanta consisting of certain census tracts in Fulton and Dekalb Counties. Other Round One Zones in Georgia are: (i) an urban-area enterprise community in Albany (the “Albany, Ga. EC”), (ii) a rural-area enterprise community in the Crisp/Dooly County area (originally called the “Crisp/Dooly County Rural EC, which in 1999 was re-designated an empowerment zone called the Southwest Georgia United Empowerment Zone), and (iii) a rural-area enterprise community in noncontiguous tracts in Burke, Hancock, Jefferson, McDuffie, Taliaferro and Warren Counties, Georgia (the “Central Savannah River Rural EC”), to wit: Burke (9502, 9504, 9508), Hancock (9801), Jefferson (9601, 9604), McDuffie (9502), Taliaferro (9902), Warren (9703, 9704). See Section 1391(b)(1) and (2) of the Internal Revenue Code of 1986, as amended (the “Code”).

The Taxpayer Relief Act of 1997 (the “1997 Act”) authorized the Secretary of HUD to designate up to 15 additional urban-area empowerment zones and to designate 2 additional new urban-area empowerment zones that were subject to the same eligibility criteria as the original six urban-area empowerment zones and authorized the Secretary of Agriculture to designate up to 5 additional rural-area empowerment zones. See Code § 1391(g). These zones are generally called “Round Two Zones” and bonds issued for projects in these zones are called “new empowerment zone facility bonds.” The Round Two Zones included the re-designation of what was formerly the Crisp/Dooly County Rural EC as the Southwest Georgia United Empowerment

Zone. Also, under the 1997 Act, certain census tracts located in the District of Columbia were designated as the “District of Columbia Empowerment Zone” (the “DC Zone”), which is subject to some special rules, which will not be discussed in this paper.

The Community Renewal Tax Relief Act of 2000 (the "2000 Act") added a new Section 1391(h) to the Code which provides that the appropriate secretary may designate 9 additional empowerment zones (but no new enterprise communities), not more than 2 in rural areas (generally called the "Round Three Zones"). Eight new urban zones have been designated, none of which are in Georgia. In addition, the 2000 Act authorized the Secretary of HUD to designate 40 renewal communities in which businesses will be eligible for tax incentives (described below) during the years 2002 through 2009. The only renewal community in Georgia is the City of Atlanta.

The designations of empowerment zones and renewal communities generally last until December 31, 2009. The designations in the case of an enterprise community last 10 years.

The tax provisions of the foregoing Acts are codified at Sections 1391 through 1397F of the Code. Final Regulations under the 1993 Act were issued in 1996 (the “EZ Regulations”). The EZ Regulations have not been amended to reflect the provisions of the 1997 Act or the 2000 Act.

Enterprise Zone Business

In order to be entitled to certain federal tax incentives, a business must qualify as an “enterprise zone business” (“EZB”). To qualify as an EZB, the business must meet the definition of “qualified business.” The following businesses do not qualify: (i) the rental of residential real property, (ii) the rental of commercial real estate unless at least 50% of the rental income is from EZBs, (iii) the rental of personal property unless at least 50% of the rentals are to EZBs and to residents of the zone, (iv) a business that has as its predominant activity the development or holding of intangibles for sale, (v) golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, race tracks, gambling facilities, and liquor stores (and no portion of the proceeds of tax-exempt enterprise zone facility bonds (“EZ Bonds”) may finance a health club, airplane or private luxury box), (vi) farming, unless the assets used for farming are worth (the greater of cost or market) less than \$500,000, (vii) businesses which hold, as more than 5% of their assets, “nonqualified financial property”(stocks, debt instruments, partnership interests and other financial instruments, except for reasonable amounts of working capital held in cash, short-term debt instruments and accounts receivable from the sale of inventory), and (viii) businesses that hold, as more than 5% of their assets, works of art or other “collectibles,” unless held for sale to customers.

At least 50% of an EZB’s gross income has to be derived from the conduct of business within the zone. Under the Income Tax Regulations (the “EZ Regulations”) income from sales generally qualify if the business making the sale is located inside the zone, whether or not the purchaser is located in the zone.

At least 35% of the employees of an EZB must be residents of the zone. The EZB may rely in good faith on a certificate from each employee, signed under penalties of perjury, that includes the employee's name and address and provides that the employee will notify the employer of any change of residence. If an employee was a zone resident at the time of certification and thereafter moves out of the zone, this will not result in noncompliance by the employer so long as the employee continues to perform a "substantial portion" of his services as an employee in the zone and the EZB hires a zone resident for the next available position.

An EZB can be a division or branch of a larger corporation. Under the "branch store" rule, an EZB may be any trade or business that would be a "qualified business" if separately incorporated. Non-qualified activities conducted outside the zone will not be taken into account in determining such qualification. Thus, individual locations of a national chain may qualify as an EZB.

Enterprise Zone Facility Bonds

The interest on "enterprise zone facility bonds" ("EZ Bonds") is excluded from the holders' gross income for federal income tax purposes. EZ Bonds are "private activity bonds." Under the Code, EZ Bonds are a type of "exempt facility bonds" and, under the regulations, EZ Bonds are deemed to be in compliance with the "public use requirement" that is applicable to "exempt facility bonds." EZ Bonds are subject to the general restrictions that apply to private activity bonds. Interest on EZ Bonds is subject to the alternative minimum tax on individuals and corporations and the cost-of carry disallowance under section 265 of the Code, if held by a bank or financial institution.

The TEFRA approval rules are applicable, thus a proposed issuance of EZ Bonds must be approved by an elected official following a public hearing with public notice.

The average maturity of the EZ Bonds may not exceed 120% of the average economic life of the bond financed facilities.

There is a special volume cap for EZ Bonds. EZ Bonds must be designated as EZ Bonds by the local government unit that nominated the area to which the bonds relates. Hence, allocations of the zone's volume limit is controlled by that local government unit. Current refunding bonds are not counted against the volume limits, except to the extent that the amount of the refunding bonds exceeds the amount of the bonds that are retired in the refunding. In the case of EZ Bonds for projects in zones other than Round Two Zones, Section 1394(c) formerly limited the amount of EZ Bonds that may be issued for any one person in a particular zone to \$3,000,000 and limited the amount of EZ Bonds that may be issued for any one person in all zones to \$20,000,000. Section 1394(f), now provides that the limits of Section 1394(c) do not apply to EZ Bonds issued after December 31, 2001 in other than the DC Zone. This lack of a "per user" national limit makes "empowerment zone facility bonds" attractive to national chains, particularly retail stores. Now, the aggregate amount of EZ Bonds that may be issued in a zone during the entire period the zone exists (except in the DC Zone) are subject to the following volume limits: (i) \$60 million, if the zone is a rural zone [this limit would apply to the Central

Savannah River Rural EC and to the Southwest Georgia United EZ], (ii) \$130 million, if the zone is an urban zone that has a population of less than 100,000 [this limit would apply to the Albany EC] and (iii) \$230 million, if the zone is an urban zone that has a population of at least 100,000. The foregoing limits are for the term of existence of the zone, rather than an annual limit.

EZ bonds, other than “new empowerment zone facility bonds” for projects in Round Two Zones, must obtain an allocation of the regular volume cap under Section 146, which is generally applicable to private activity bonds. “New empowerment zone facility bonds” for projects in Round Two Zones do not need an allocation of volume cap under Section 146, which is generally applicable to private activity bonds. Thus, in the case of EZ Bonds that are issued for projects in the Southwest Georgia United Empowerment Zone, which is a Round Two Zone, no volume cap allocation from the Georgia Department of Community Affairs is required.

EZ Bonds are not subject to some of the special rules that are applicable to “qualified small issue” bonds. For example, EZ Bonds can be used to finance commercial facilities, subject to the EZB limitations described herein. EZ Bonds are not subject to the 25% of proceeds limitation on expenditures for land or to the restrictions on the use of bond proceeds to acquire used property (except property previously used in the zone, as described herein). Unlike the rule applicable to “qualified small issue” bonds to which the \$10 million limit on bonds and certain capital expenditure applies, there is no restriction on the amount of capital expenditures that may be financed from sources other than proceeds of the EZ Bonds.

To qualify for EZ Bond financing, 95% or more of the proceeds must be used by a principal user that qualifies as an EZB, except: (a) during a “start-up period” and (b) after the “testing period.” The regulations define “principal user” as the owner of the financed facility or a lessee who operates a qualified business on the financed property. The term “start-up period” means, with respect to any property being provided to any business, the period before the business’s first tax year beginning more than two years after the later of (i) the issue date of the EZ Bonds providing such property or (ii) the date such property is placed in service (or, if earlier, the date which is 3 years after the issue date). To be entitled to a “start-up period,” the business must reasonably expect on the issue date that it will qualify as an EZB by the end of the “start up period” and the business must make bona fide efforts to qualify as an EZB during the “start-up period.” The “testing period” is the first three tax years of the business commencing after the expiration of the “start up period.” After the end of the testing period, all requirements of the definition of EZB are waived except the requirement that at least 35% of the employees of the business be residents of the zone.

If there is a failure to comply with the EZB requirements during the testing period or thereafter with the 35% of employees residency requirement, the business will not be allowed a tax deduction for the interest expense related to the EZ Bonds until a cure is accomplished. This penalty applies in lieu of the general change in use rules applicable to tax-exempt bonds. Under the regulations, the requirements will be deemed to be satisfied if the issuer and the business try to meet the requirements in good faith and cure any failure to comply within one year of

discovery of noncompliance. That “good faith” test is met if the principal user annually demonstrates to the issuer that the principal user is monitoring compliance with the requirements.

The property financed with the proceeds of EZ Bonds must constitute “qualified zone property” (“QZP”). QZP includes land for the project site, buildings, equipment and other capital “hard assets” which meet either an “original use” test or a “substantial renovation” test. Under the “original use” test: (i) the EZB must purchase or construct the property after the designation of the zone, (ii) the “original use” of the property in the zone must commence with the EZB [the property may have been previously used outside the zone, but not within the zone], and (iii) substantially all use of the property must be in the active conduct of a qualified business in the zone. A special rule on sale and leasebacks allows a newly constructed facility to be sold and leased back within 3 months of completion and still be treated as “original use” property. The regulations allow for the purchase of property that has been abandoned for a period in excess of one year, if that period includes the date of zone designation. The “substantial renovation” rule permits a business to use EZ bonds to finance the purchase of a building that will then be substantially renovated. The renovation test requires the renovation to occur during any 24 month period after the date on which the zone designation became effective. The business may use bond proceeds to pay for the building or the cost of renovation. Bond proceeds may also be used to renovate a building the business already owns. The property to be renovated need not have been acquired by the business after the designation of the zone and need not have been originally used by the business within the zone. The Code does not provide a specific test as to what the renovation must accomplish, or what type of expenditures will qualify. Improvements do not qualify as a “substantial renovation” unless they add to the tax basis of existing property. Thus, improvements to a leasehold by a tenant under a true lease will not qualify as “substantial renovations;” instead, the improvements qualify for EZ Bond financing as “original use” property. The amount expended on renovations during the 24 month period must exceed the greater of 15% of the tax basis of the property at the beginning of the period or \$5,000.

Federal Tax Incentives in Addition to Tax-Exempt Bonds

Empowerment Zone Employment Tax Credit. Under Section 1396 of the Code, a business (it need not be an EZB), located in a regular zone (but not in an enterprise community), may qualify for a tax credit of up to \$3,000 per year for “qualified zone wages” paid to an employee who, during the period for calculation of the credit, is a zone resident who performs a “substantial portion” of his services in the zone (individuals that work in the D.C. zone are not required to live in that zone). The percentage of wages that may be taken into account in the calculation of the credit is 20%. For more information on the empowerment zone tax credit, *see* IRS Form 9944

Increased Section 179 Deduction. An EZB located in an empowerment zone (but not in an enterprise community) may take an expense deduction of up to \$35,000 (instead of the normal \$15,000 deduction) per year on purchases of equipment for use in such zone. For more information about the Section 179 deduction, *see* IRS Publication 946.

Rollover of Gain from Sale of Empowerment Zone Assets. A taxpayer may qualify for a tax-free rollover of certain gains from the sale of qualified empowerment zone assets, including stock or partnership interests in a EZB and certain tangible property used in a EZB. To qualify the following tests must be met: (i) the qualified empowerment zone asset must have been held for more than 1 year, (ii) the gain on sale must be a capital gain, and (iii) during the 60-day period beginning on the date of sale, the taxpayer must buy a replacement qualified empowerment zone asset in the same zone. A taxpayer that elects to use this rollover provision will recognize only up to the following amount of gain: (1) the amount realized on sale, minus (2) the cost of the replacement qualified empowerment zone asset purchased within the 60-day period. The amount of non-recognized gain is subtracted from the cost basis of the replacement assets. For more information about this rollover, *see* Section 1397B of the Code

Increased Exclusions of Gain from Qualified Small Business Stock. Taxpayers, other than corporation, can generally exclude from income 50% of the gain from then sale of qualified small business stock held for more than 5 years. If the stock is stock of a corporation that qualifies as a EZB 60% of the gain (in lieu of 50%) can be excluded. To qualify for this increase exclusion, the stock must have been acquired after December 21, 2000. For more information about this exclusion, *see* Chapter 4 of IRS Publication 550.

QZABs. The 1997 Act, as a part of its educational incentives, has provided for the issuance of "qualified zone academy bonds" to benefit public schools (or academic programs within public schools) if (i) such school is located in an empowerment zone or enterprise community or (ii) if there is a reasonable expectation that at least 35% of the students will be eligible for free or cost reduced lunches under the National School Lunch Act). The bonds bear no interest. Instead, a financial institution that holds such bonds is entitled to a nonrefundable federal income tax credit that is a percentage, established monthly by the U.S. Treasury Department, of the amount of bonds held by such eligible taxpayer.

RENEWAL COMMUNITIES

Pursuant to the 2000 Act, the Secretary of HUD designate 40 renewal communities in which businesses will be eligible for tax incentives (described below) during the years 2002 through 2009. The only Renewal Community in Georgia is the City of Atlanta. The areas eligible for these incentives were selected from nominations submitted by State and local governments. To be eligible for most of the tax incentives, a business must be considered a "renewal community business" (an actively conducted "qualified business" within a designated renewal community where at least 50% of its total gross income comes from such "qualified business"; at least 35% of the employees must live in the renewal community and a substantial portion of their services must be performed in the renewal community). Certain limitations may also apply in order to fully utilize these tax incentives. Beginning January 1, 2002, and ending December 31, 2009, the tax incentives generally available are:

a. Additional Section 179 Expensing: Section 179 of the Code allows a taxpayer to choose to deduct all or part of the cost of qualifying property in the first year it is used in business, instead of depreciating it over a number of years. There is a dollar limit on how much a

business can deduct. Certain phase out rules and special rules apply. Property that is substantially renovated also has unique rules.

b. Zero-percent Capital Gain Rate: A zero-percent capital gains rate applies to sales or exchanges of qualified community assets acquired after December 31, 2001 and before January 1, 2010 and held for more than five years. "Qualified community assets" include qualified community stock, community partnership interests and community business property that is purchased or substantially improved after December 31, 2001. For more information on this deduction, *see* Section 1400F of the Code.

c. Commercial Revitalization Deduction: "Commercial revitalization expenditures" include expenditures chargeable to a capital account for depreciable property that is nonresidential rental property, or Section 1250 property that is related to nonresidential real property. To qualify, the building and its structural components must be placed in service in a renewal community before 2010. If the building is new, the original use of the building must begin with the taxpayer. If the building is not new, the taxpayer must substantially rehabilitate the building. The cost of the building or costs to substantially rehabilitate an existing building are subject to certain limitations. Each state is permitted to allocate up to \$12 million of "commercial revitalization expenditures" to each renewal community located within the state. A taxpayer that receives a share of the allocated "commercial revitalization expenditures" from your state, can choose one of two ways to reflect this on his or its federal tax return: (i) the taxpayer may deduct one half of the commercial revitalization expenditures in the first year or (ii) can amortize 100% of the expenditures over 120 months. The taxpayer will not be able to claim depreciation for these amounts and in total the taxpayer cannot claim more than \$10 million of these expenses for any one building. The building must be located within the renewal community and used for commercial purposes. The taxpayer must submit a qualified allocation plan to an appropriate State agency. For more information on this deduction, See Section 1400I of the Code.

d. Renewal Community Employment Credit: Any business within the Renewal Community is eligible for this credit and does not have to meet the definition of "renewal community business." An employer is eligible for a credit of 15% of the first \$10,000 of qualified wages paid to each "qualified employee" (a full-time or part-time employees employed for at least 90 calendar days, who lives and works within the renewal community, does not own more than 5% of the employer stock and for certain relatives and dependents thereof). There is a \$1,500 limit per qualified employee. Also certain business activities described by the Internal Revenue Code or certain farming activities preclude the use of this credit. The deduction for wages is reduced by the amount of the credit.

For additional general information on these and other incentives, reference is made to IRS Publication 954, "Tax Incentives for Empowerment Zones and Other Distressed Communities." IRS Publications and Forms can be obtain from the Internal Revenue Service website at www.irs.gov.

CONCLUSION

In summary, in Georgia there are two empowerment zones (Atlanta and the Southwest Georgia United Empowerment Zone), two enterprise communities (Albany, Ga. EC and Central Savannah River Rural EC) and one renewal community (Atlanta). Companies that are located in these areas may be entitled to one or more of the federal tax and financing incentives, discussed above.

MORE INFORMATION

This White Paper is a quick-reference guide for company executives and managers, participants in this real estate and financial industries, economic developers, and their advisors. The information in this White Paper is general in nature. Various points which could be important in a particular case have been condensed or omitted in the interest of readability. Specific professional advice should be obtained before this information is applied to any particular case. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

If you have any questions or comments, we would be pleased to provide more information. Please contact:

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