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EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

ASSOCIATE DIRECTOR
FOR NATURAL RESOURCES,
ENERGY AND SCIENCE

DCF HAS SEEN

June 4, 1992.

NOTE TO Sec. Skinner

Gen. Scowcroft

Sec. Mauter

Boyden Gray

Mike Deland

Marlin Fitzwater

Under Secretary Zoellick

Mr. Melby

File

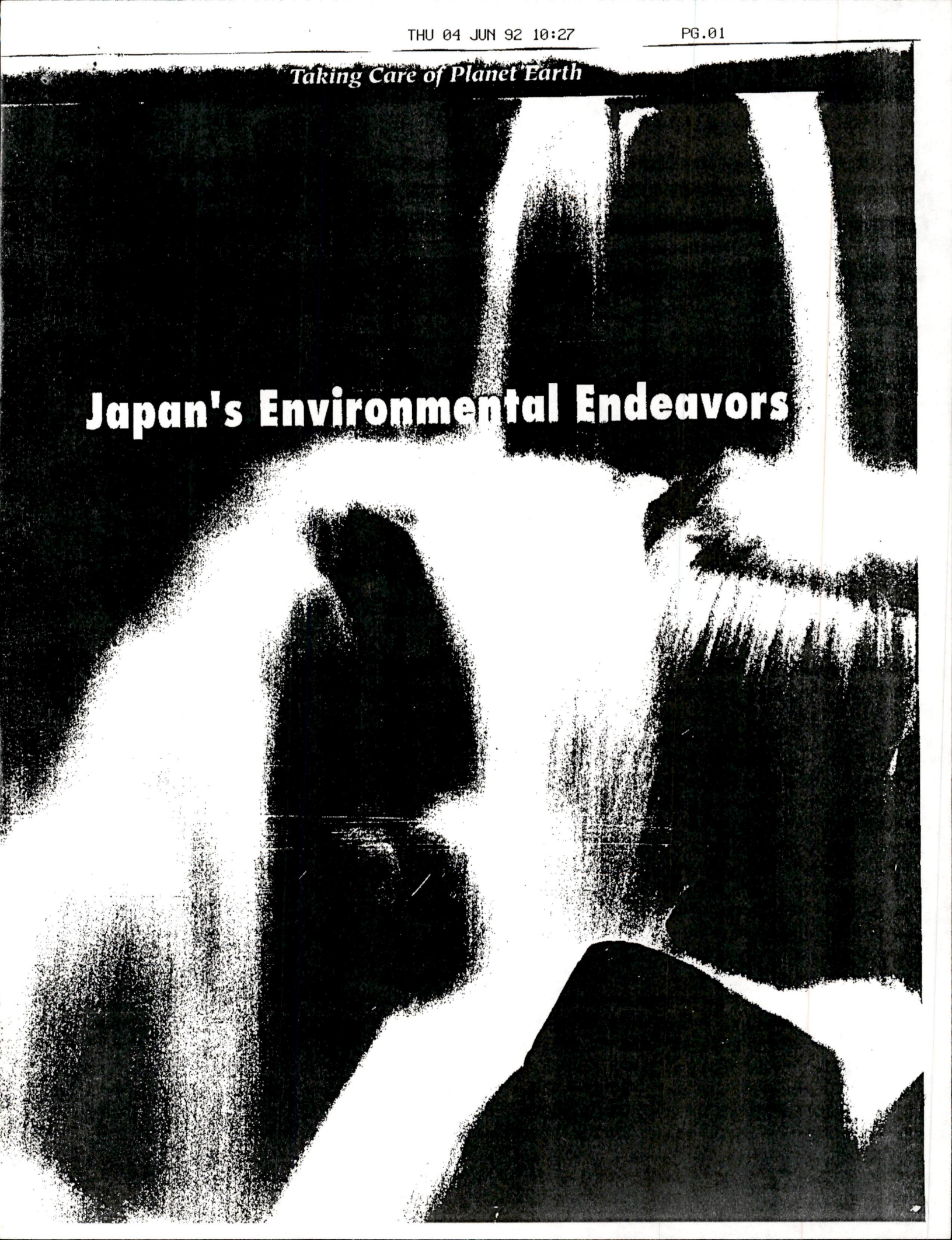
Attached FYI is an environmental
brochure being distributed by the Japanese
at Rio.

Note the distinctly anti-U.S. flavor
of the presentation of the charts.

Bob Grady.

Taking Care of Planet Earth

Japan's Environmental Endeavors

A high-contrast, black and white photograph of a waterfall, serving as the background for the page. The image is grainy and has a stark, almost abstract quality due to the extreme contrast between the dark water and the bright spray and surrounding areas.

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Introduction

Population growth and economic development are turning environmental problems, such as global warming, ozone layer destruction, tropical forest reduction, and air and water pollution, into life-threatening issues not only for the world's species of flora and fauna but for humans as well.

In this day of economic activities that spread beyond national borders and of growing interdependence among the nations of the world, these global environmental issues cannot be solved through the efforts of any single nation. All countries must focus their collective wisdom and knowledge on taking suitable measures to solve these issues in order to ensure the survival and the flourishing of the human race.

While maintaining high economic growth and applying its knowledge and technology gained through extensive experience in successfully handling industrial pollution, Japan, in line with its fundamental foreign policy of "Japan contributing to the world," is aggressively addressing the various problems of the global environment. This approach is based on the following:

- (1) Preserving the global environment while maintaining the stable development of the world economy
- (2) Pursuing all possible technological methods, as well as emphasizing a scientific approach as the basis for preserving the global environment
- (3) Taking global measures in cooperation with all nations and related international institutions to preserve the environment as the common base of survival for the human race
- (4) Implementing environmental measures on the international level by securing the participation of the developing nations with due consideration given to their respective situations, and placing greater attention on the environment while supporting these nations in their efforts to achieve sustainable development

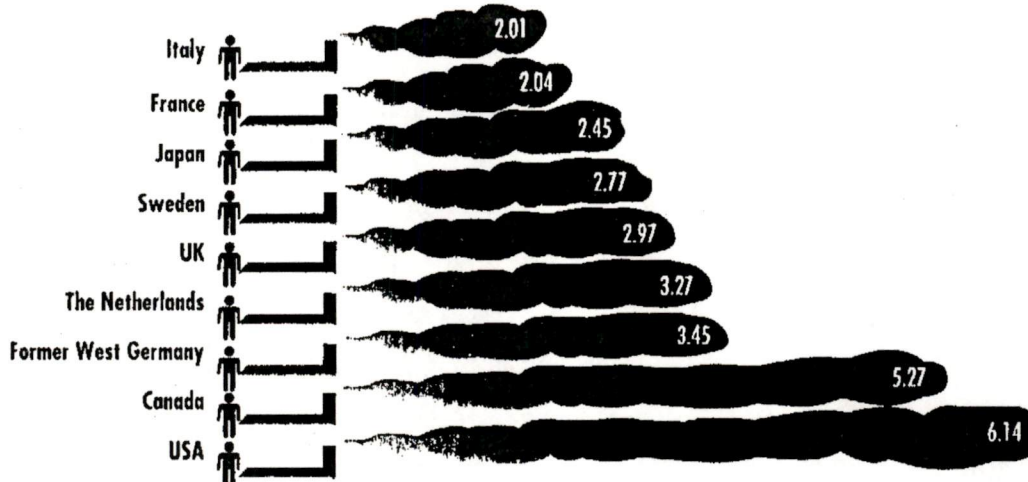
Herein introduced are the measures Japan is taking globally with regard to environmental issues.

Prevention of Global Warming

Regulating carbon dioxide emissions through effective use of energy-saving measures

• Comparison of Per Capita Carbon Dioxide Emissions (1988)

Unit: tons carbon per capita



Note: Figures for carbon dioxide are for fossil fuels only.

Source: OECD Energy Balance 1988

What is Global Warming?

Known as the greenhouse effect, increased emissions of gases, such as carbon dioxide and methane, increase the density of the greenhouse gases in the atmosphere, thus predictably causing global temperatures to rise. The estimated 5.89 billion tons of carbon dioxide (1988) emitted annually throughout the world is said to be the main cause of this warming, and an Intergovernmental Panel for Climate Change (IPCC) report warns that such warming can endanger agriculture, forestry, and ecosystems, as well as raise sea levels.

To Control Global-Warming Gases

To prevent an increase in global warming, it is important that global-warming gases be controlled and that economic and environmental policies be balanced. Therefore, the use of energy that emits less carbon dioxide should be encouraged, and city planning, manufacturing methods, and mass transportation systems should be pursued that do not increase the level of global warming. Further, national life styles that take in the need of maintaining a safe environment should be supported.

Energy Efficiency—The Highest Level Among Major Developed Countries

To arrest global warming, it is important to improve energy efficiency and curb carbon dioxide emissions caused by energy consumption. After the two oil crises in the 1970s, progress was made in Japan's energy conservation, particularly in the industrial sector, by the promotion of policies based on the Law Concerning the Rational Use of Energy and through active investment in equipment by the private sector. As a result, since the mid-1970s energy efficiency in Japan has steadily improved and Japan has now attained the highest level among the major developed countries. To cite an example, the level of carbon dioxide emissions per capita in Japan is one of the lowest among these countries.

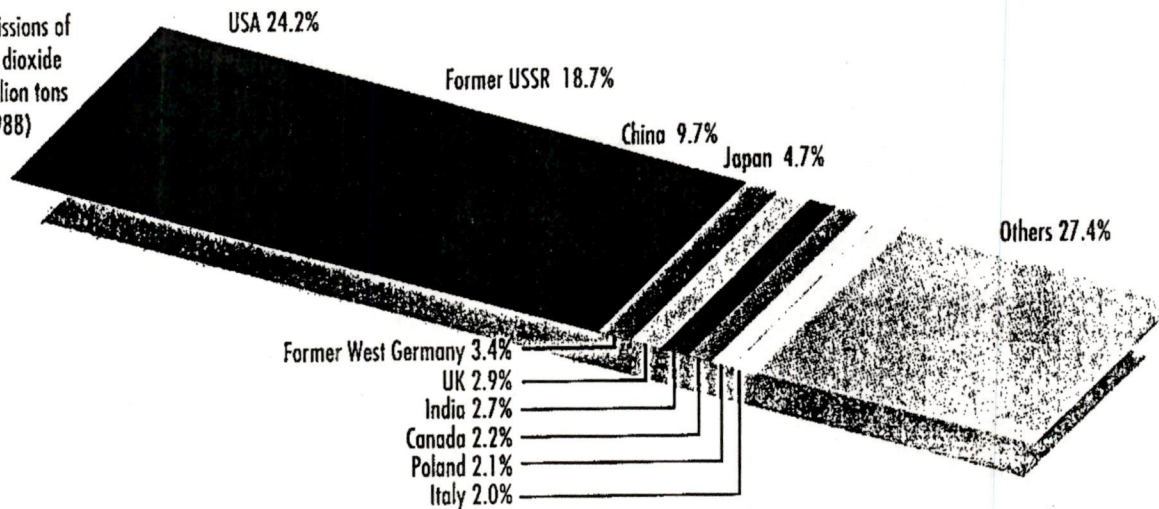
An Action Program to Prevent Global Warming

Japan is playing a leading role in combating global warming through international cooperation by sharing its advanced technology and experience in environmental protection.

Prevention of Global Warming

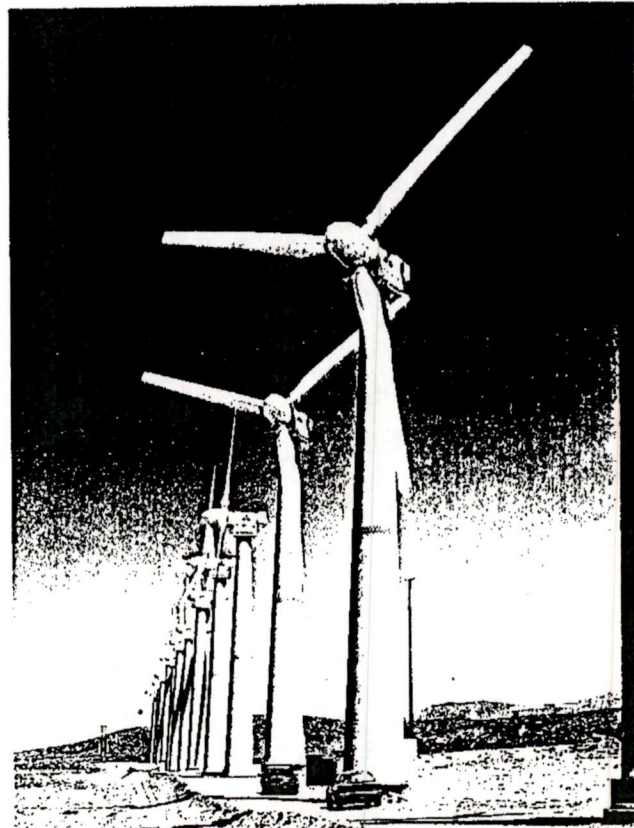
• World Carbon Dioxide Emissions (1988)

Total emissions of
carbon dioxide
5.89 billion tons
(1988)



Source: United Nations Energy Statistics

With this goal in mind, in 1990 Japan announced an Action Program to Arrest Global Warming. Setting the year 2000 and beyond as the target, this program calls for stabilizing the amount of carbon dioxide emissions at the 1990 level on a per capita basis and a total basis through developing innovative technologies at a faster pace and on a greater scale than currently envisaged. Based on this plan, Japan has already taken preventative measures to control carbon dioxide emissions in many fields, such as industry, energy, city planning, mass transportation, and in its national life style. One example is the introduction and promotion of a cogeneration system that dramatically improves energy efficiency from the current 35% level to approximately 70%. Japan also is pursuing research and development at a new WMO World Data Center for Greenhouse Gases.



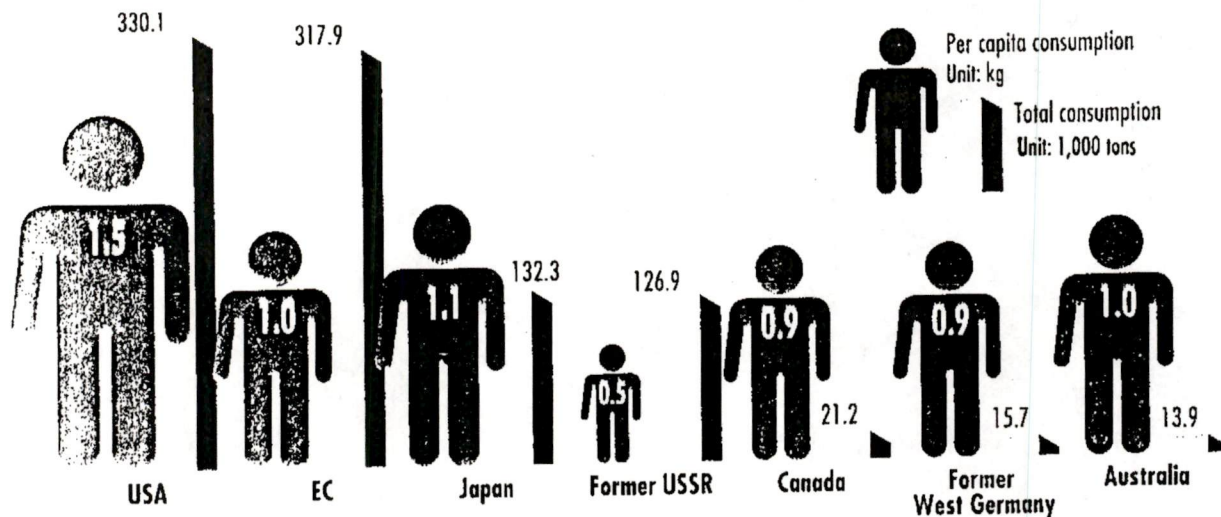
Wind-generated electric power

Mitsubishi Heavy Industries Ltd.

Protection of the Ozone Layer

Aiming for total phase-out of production and consumption of controlled chlorofluorocarbons and halons in Japan by the year 2000

• Consumption of Controlled CFCs and Halons in Major Nations (1986)



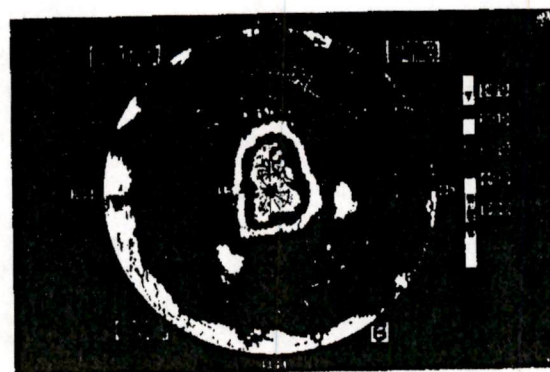
Source: UNEP, Statistical Yearbook (1986)

Destruction of the Ozone Layer

The ozone layer absorbs harmful ultraviolet rays (wavelengths between 280 and 315 nm), preventing them from reaching our planet and causing chemical changes to DNA, the source of life.

In 1985, Joseph Farman of the British Antarctic Research Committee and meteorological laboratory researcher Shigeru Chubachi of the Meteorological Research Institute in Japan attracted world attention with their discovery that ozone levels over Antarctica had become severely depleted. Should this ozone layer be destroyed, an increase in the incidence of such physical ailments as cataracts and skin cancer would occur, as well as widespread damage to our ecosystems. The chief causes of ozone depletion are chlorofluorocarbons (CFCs) and halons used by industry as refrigerants in air conditioners, propellants in aerosol sprays, and as cleansers for electronic parts.

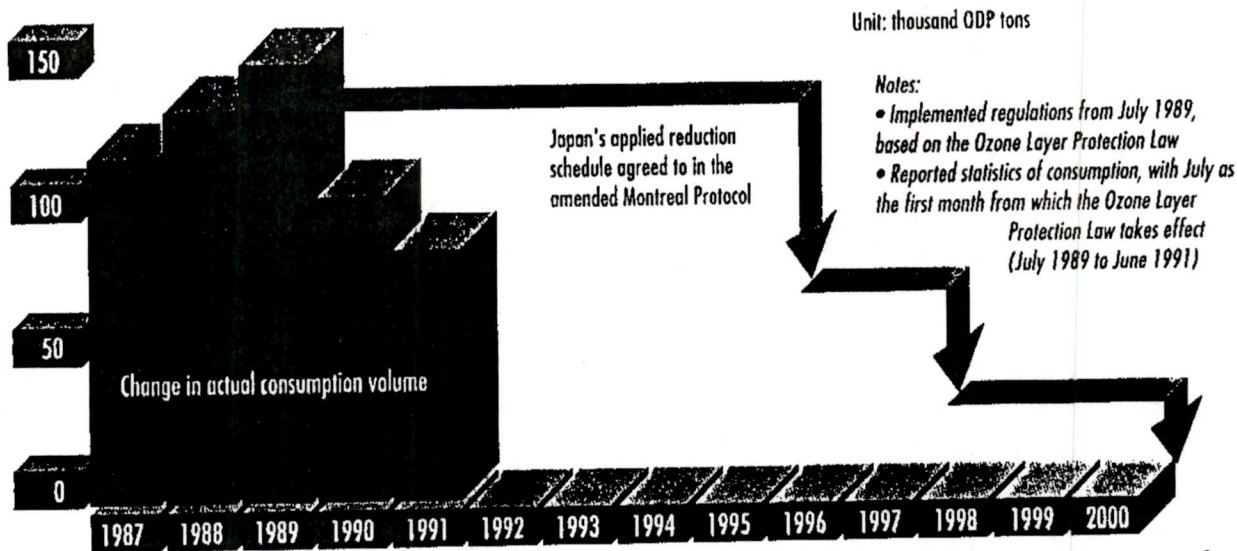
To eliminate the source of this destruction, it is vitally important to take action internationally.



Photographs of the ozone hole (green area) over Antarctica in 1982 (above) and 1989 (below)

Protection of the Ozone Layer

• Changes in Consumption of Controlled CFCs and Schedule to Reduce Consumption in Japan



Source: MITI

International Measures

The 1985 Vienna Convention for the Protection of the Ozone Layer, and the 1987 Montreal Protocol on Substances that Deplete the Ozone Layer are two important international measures for protecting the ozone layer. Included in these measures is a pledge to reduce CFC usage by 50% within ten years. At the second meeting of the Montreal Protocol held June 1990 in London, participants further agreed to the total phase-out of controlled CFCs by the year 2000 and to establish a fund to assist developing nations.

Total Phase-out of Consumption and Production of Controlled CFCs and Halons

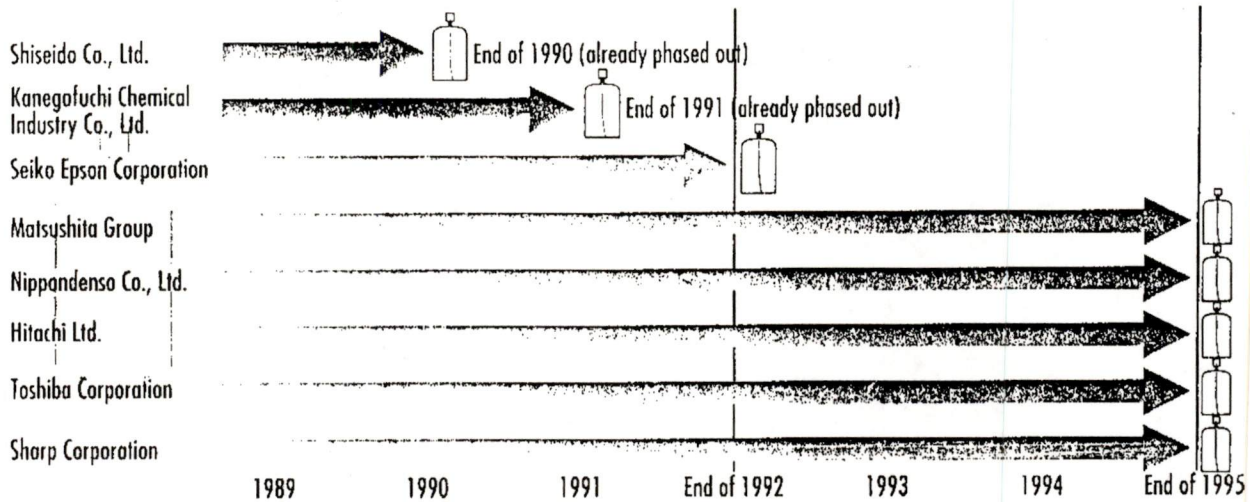
In Japan, some protective measures have already been implemented toward the total phase-out of controlled CFCs and halons by the year 2000. Based on the Law Concerning the Protection of the Ozone Layer through the Control of Specified Substances and other measures established in 1988 and amended in 1991, both the production and consumption of such CFCs have been steadily reduced based on the schedule of the Montreal Protocol.

Technical Development to Restrain CFC Emissions

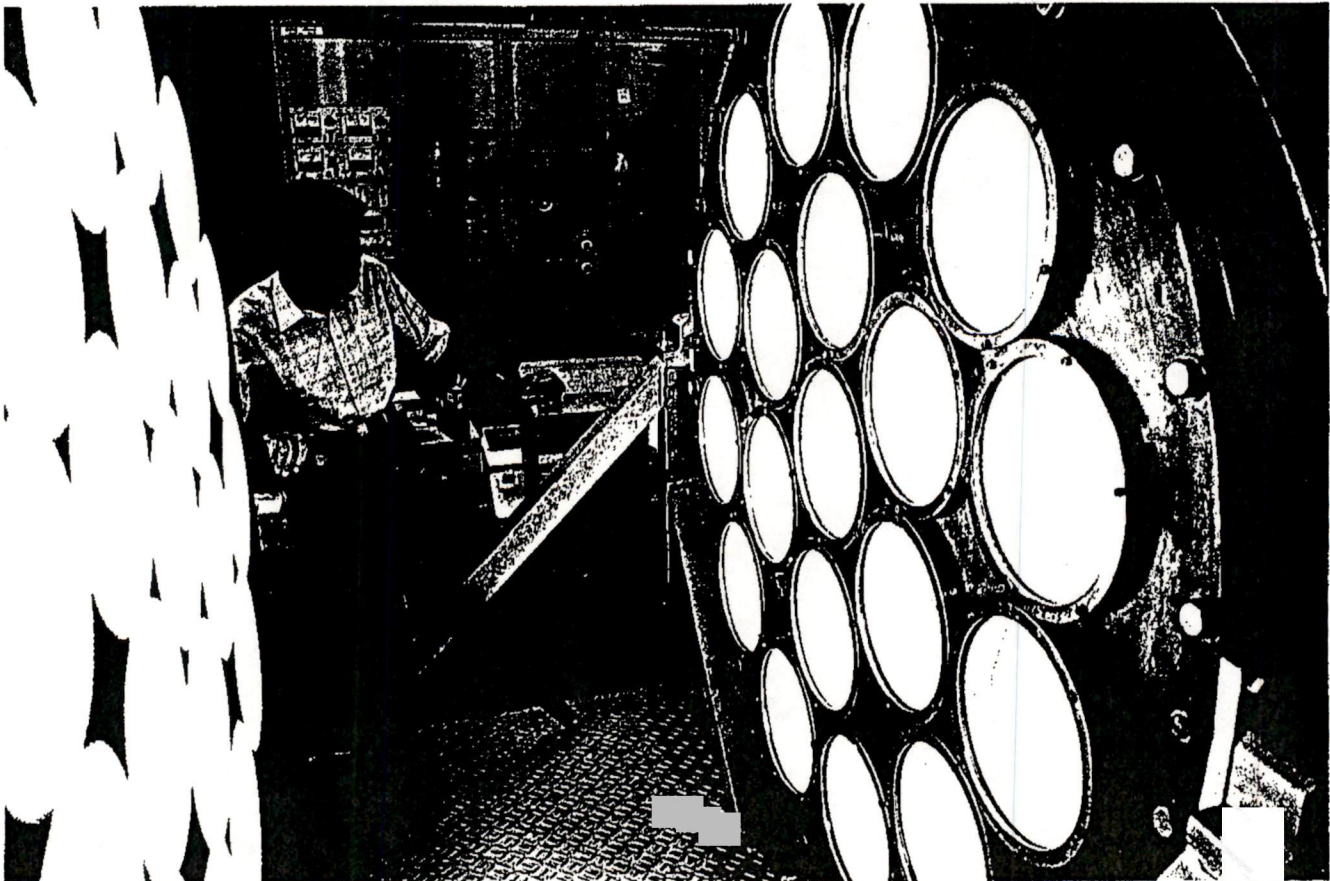
Presently, many industrial companies are aggressively attempting to reduce CFC use through the development of devices that limit CFC emissions, the recycling of collected CFCs, and the development of suitable alternatives. As a result, Japanese production and consumption of controlled CFCs have been greatly reduced. As of 1990, CFC production has decreased by approximately 26% and consumption by 33% in comparison to the 1989 levels.

Protection of the Ozone Layer

• CFC Phase-out Plans in Major Companies



Source: MITI



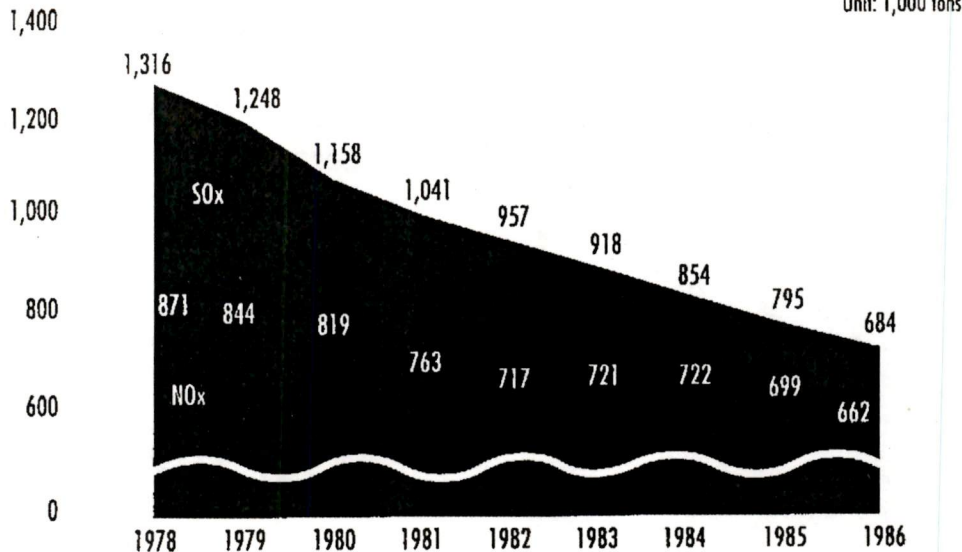
Jiji Gakko Sha Inc.

Photochemical reaction chamber for demonstrating the occurrence and mechanism of ozone destruction

Acid Rain Countermeasures

Japanese emission controls are the strictest in the world. Seventy-six percent of the world's desulfurization and denitrification plants are located in Japan.

• Changes in SO_x and NO_x Emissions from Stationary Sources in Japan



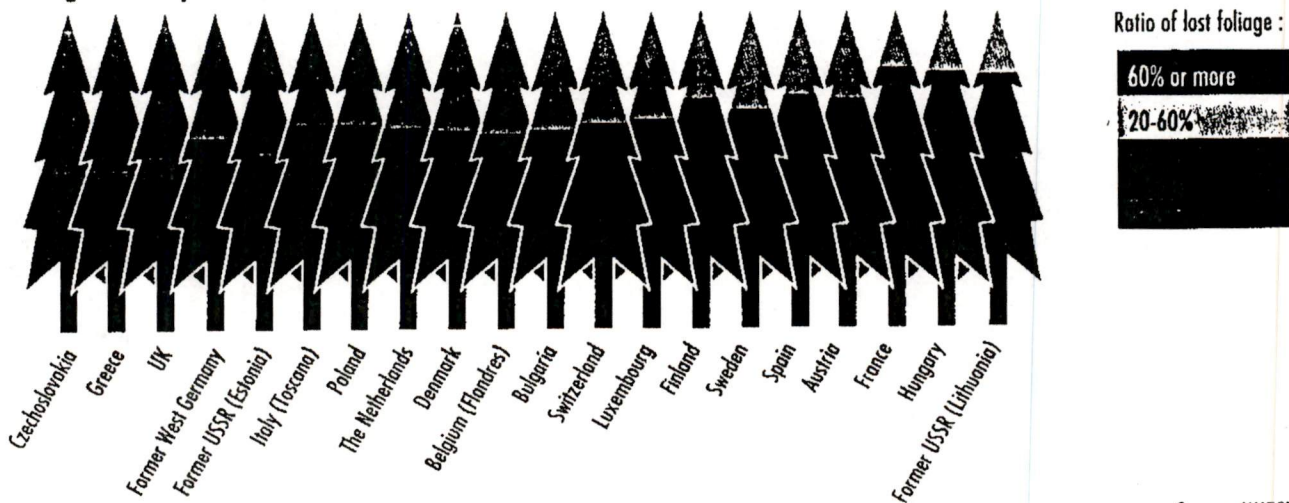
Source: Environment Agency

Acid Rain

Precipitation with a pH value of 5.6 or less is called acid rain, which develops when air absorbs sulfur oxides (SO_x) and nitrogen oxides (NO_x) produced by burning fossil fuels. As air currents can carry acid rain several thousand kilometers from the source of pollution before depositing it, acid rain crosses borders to become a serious

problem affecting many nations. According to a United Nations Economic Commission for Europe survey conducted in 1987, more than 30% of Europe's forests have been damaged by acid rain and air pollution. Acid rain also acidifies the soil and bodies of water, damaging vegetation and the growth of fish species such as salmon and trout. Even marble and metal structures are eroded.

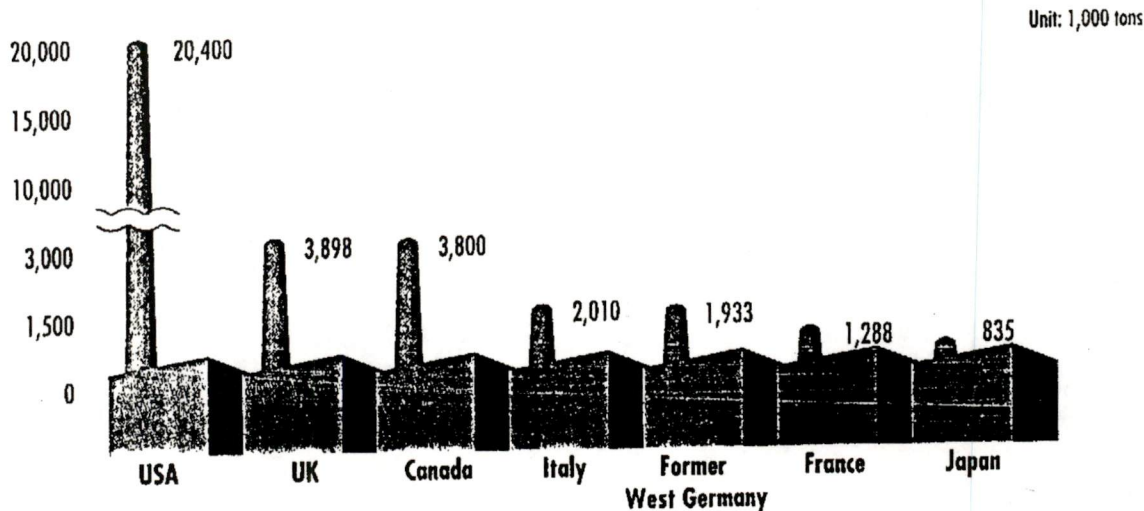
• Damage to European Forests from Acid Rain and Air Pollution (1988)



Source: UNECE

Acid Rain Countermeasures

• Comparison of Sulfur Oxide Emissions (1987)



Note: Japanese figures as of 1986

Source: OECD Environmental Data

Strict Emission Controls

Japanese environmental standards for SO_x and NO_x emissions, as well as for other particles associated with acid rain, are the strictest in the world. Regulations stipulate that the level of nitrogen dioxides in the air should not exceed 0.02-0.03 ppm, expressed as an annual average. Since 1973, Japan has regulated NO_x emissions from commercial and industrial sources. Also, automobile NO_x emissions in Japan are strictly regulated. Since 1977, gasoline-powered passenger vehicles have been required to decrease NO_x emissions by 90%. This level has already been achieved.

• Atmospheric Environment Standards in Japan, the United States, and Former West Germany

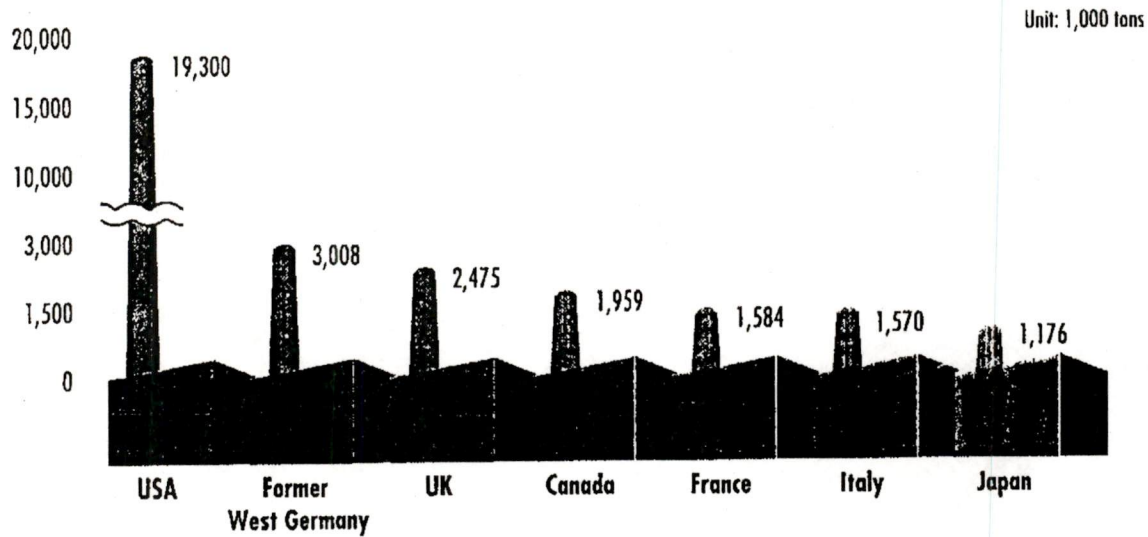
		Japan	USA	Former West Germany
SO ₂ (ppm)	Per day	0.04	0.14	—
	Per year	—	0.03	0.05
NO ₂ (ppm)	Per day	0.04 ~ 0.06	—	—
	Per year	*(0.02 ~ 0.03)	0.05	0.04
PM (mg/m ³)	Per day	0.10	0.15	—
	Per year	—	0.05	0.15

*Calculation based on daily amounts

Source: Environmental Administration Handbook, Environment Agency

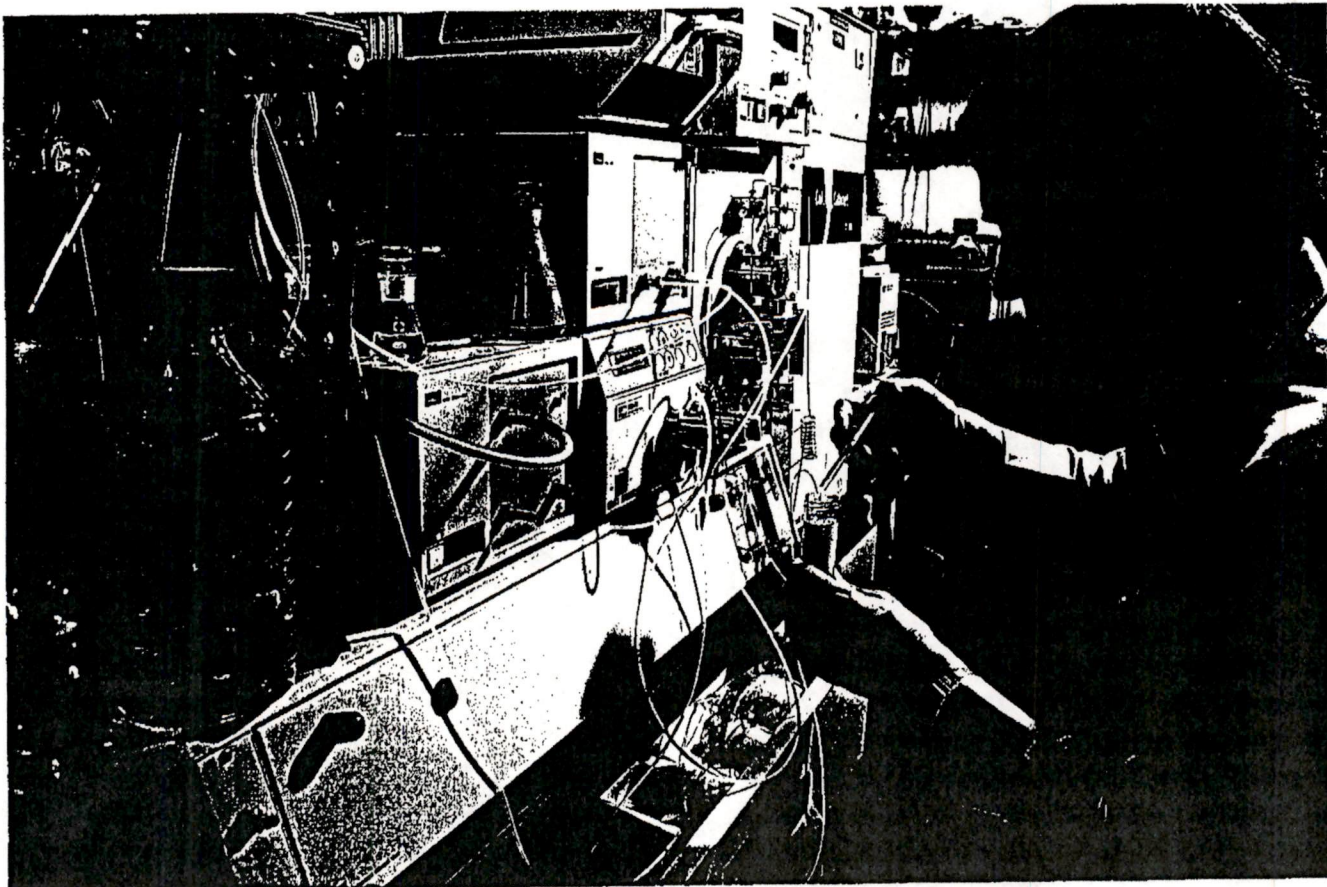
Acid Rain Countermeasures

• Comparison of Nitrogen Oxide Emissions (1986)



Note: Canadian figures as of 1985

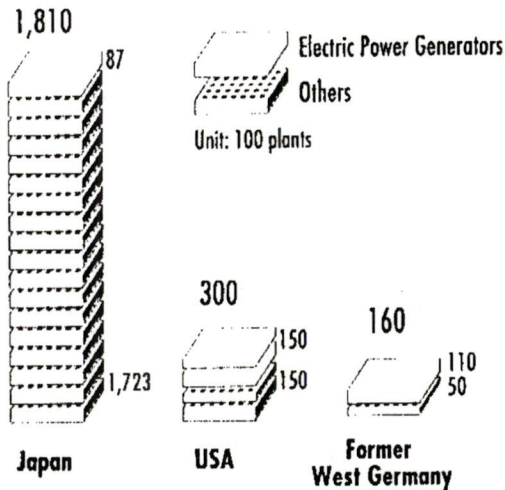
Source: OECD Environmental Data



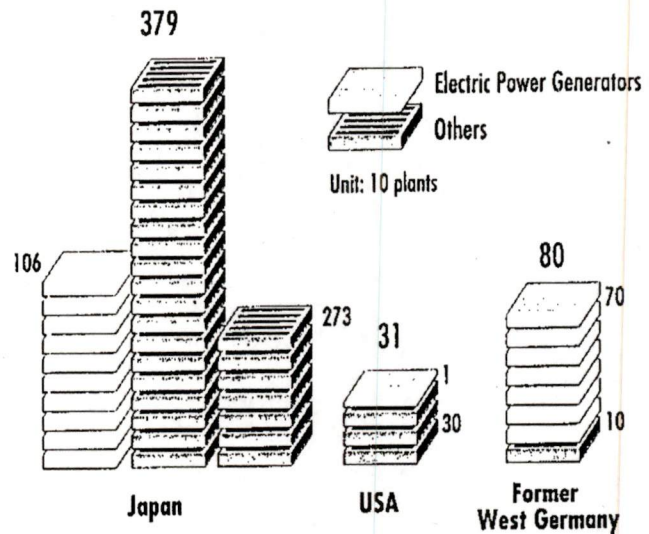
Members of an acid deposition research team studying acid fog with a mist sample

Acid Rain Countermeasures

• Number of Desulfurization Plants (1989)



• Number of Denitrification Plants (1989)

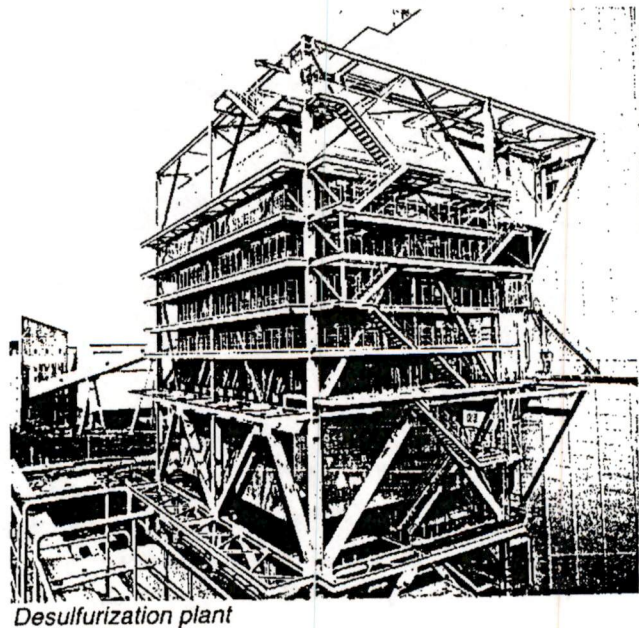


Source: "World's Emission Purification Techniques," Coal Technical Research Institute

Desulfurization and Denitrification Plants

Japan's 2,189 desulfurization and denitrification plants represent the highest number of such plants in the world: 76% of the global total (1989)—more than six times the number of plants in the United States and seven times that of former West Germany.

Private companies use fuels with low sulfur levels or enhanced fuels to meet Japan's strict standards. Through these efforts, SO_x and NO_x emissions are maintained at a very low level. Japan's SO_x emission level is 4% that of the U.S., 21% that of the United Kingdom, 43% that of former West Germany, and 41% that of Italy. Similarly, Japan's total NO_x emission is 6% that of the U.S., 40% that of former West Germany, and 48% that of the United Kingdom.



Protection of Tropical Forests

Through the cooperation of private enterprise, the government, and the general public, the nation strives to conserve the world's resources.



JICA

Green cooperation project in Niger

Depletion of Tropical Forests—Situation and Cause

Nearly half of the world's species of flora and fauna exist in tropical forests. According to a United Nations Food and Agriculture Organization (FAO) survey, seventeen million hectares of these forests, equivalent to half the size of Japan, are estimated to be lost yearly. Tropical forest destruction occurs in Central and South America, Africa, and Asia. The principal causes of this destruction are said to be the use of non-traditional shifting cultivation, excessive gathering of firewood and charcoal, the use of agricultural land for other purposes, overgrazing, and inappropriate commercial logging. Many of these activities occur as a result of socioeconomic factors which include poverty and population growth. Further, almost 80% of all harvested tropical timber worldwide is consumed locally as fuel, with only 3% of the remaining 20% being exported.

Advocating and Undertaking "Environmentally Friendly Three Principles on Tropical Timber Trade"

Realizing the need to conserve tropical forests and balancing this conservation with continued economic growth, Japan has been supporting the activities of the International Tropical Timber Organization (ITTO), in which timber producers and consumers have united their efforts in forest conservation. As regards trade in tropical timber, Japan actively promotes and advocates a program called "Environmentally Friendly Three Principles on Tropical Timber Trade" so as to achieve ITTO's target for the year 2000 of having all tropical timber product exports come from sustainable, managed resources. These principles are:

- (1) Monitoring tropical timber trade
- (2) Diversifying tropical forest products as well as increasing the value added
- (3) Developing greater efficiency in the use of tropical timber resources

Protection of Tropical Forests



Jip Gato Sina Inc.

A tropical forest reserve on Borneo island, Indonesia

Measures to achieve these goals include:

- (1) Requiring major tropical timber importers to report their imports and prospects regarding future imports to their governments
- (2) Technical assistance to tropical timber-producing countries to improve timber-processing technology
- (3) The further development of technology for multiple use of "concrete panels"

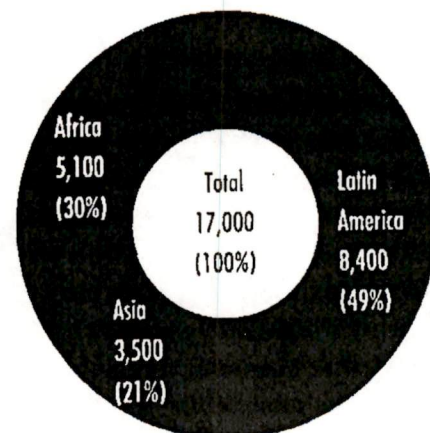
Reforestation in Developing Countries

The preservation of its forests is rooted in the culture of Japan, which is blessed with an abundance of greenery; 68% of its land is covered with forests, 40% of which represents plantations. Japan now shares its extensive experience in forestry preservation with developing countries. Japan's official cooperation, which builds centers for developing reforestation techniques, dispatches experts to train local foresters, accepts trainees, provides help for tree-planting, and combines some or all of the abovementioned activities, has been extended to Asia, the Pacific, Africa, and

Central and South America to maintain their forests. For example, Japan has contributed to the greening of over 8,000 hectares in the Pantabangan area in the Philippines and a 3,000-hectare area of South Sumatra, Indonesia. As of January 1992, fourteen such support projects in twelve countries have been undertaken.

• Average Annual Deforestation

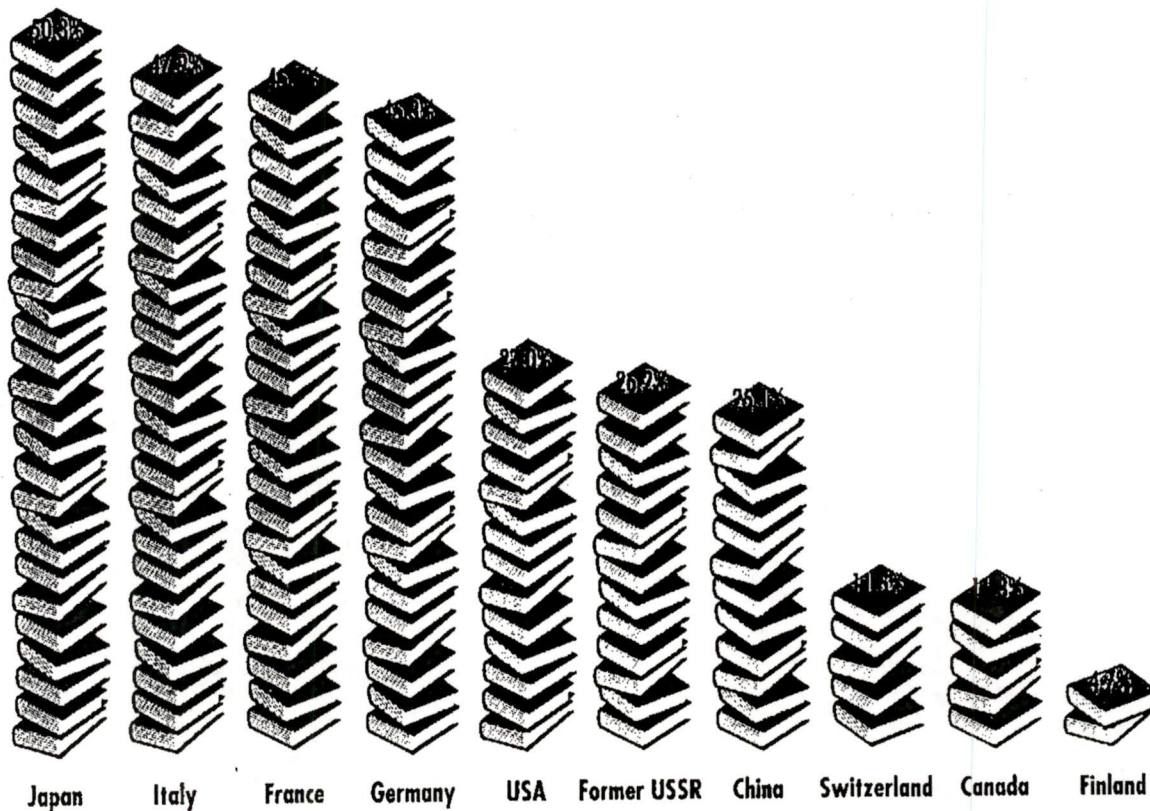
Unit: thousand hectares



Source: Forest Resource Assessment
1990 Project, FAO

Protection of Tropical Forests

• Used Paper Utilization Rate (1989)



Note: Utilization rate=Consumption of old paper/paper and pasteboard production

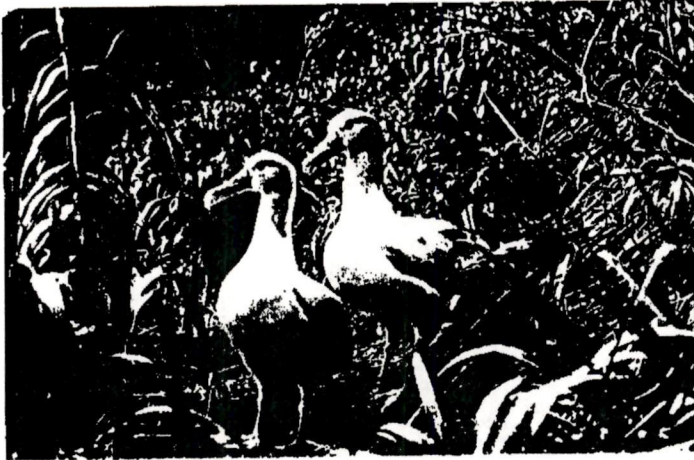
Source: Japan Paper Association

Japan in the Forefront of Paper Recycling

Japan has been actively promoting the recycling of paper to better utilize forest resources. Citizens, private companies, and government offices now separate used paper from their rubbish, so that the paper can be collected for recycling. Government offices and private companies are further encouraged to use recycled paper for photocopying documents and wrapping. Because of these efforts, Japan has achieved a 50.3% recycling utilization rate, the highest in the world.

Protecting Wildlife

Grass-roots observance of international agreements to ensure the preservation of all species



The short tailed albatross



High-moor

Both photos courtesy of the Environment Agency

World Wildlife Situation

Almost 3,000 of the world's animal species and 16,000 of the world's plant species are in danger of extinction as a result of destruction to the natural environment. As the earth's ecosystems vitally depend on the interaction of its wildlife, humankind must find a way to harmoniously coexist with nature.

Wildlife Situation in Japan

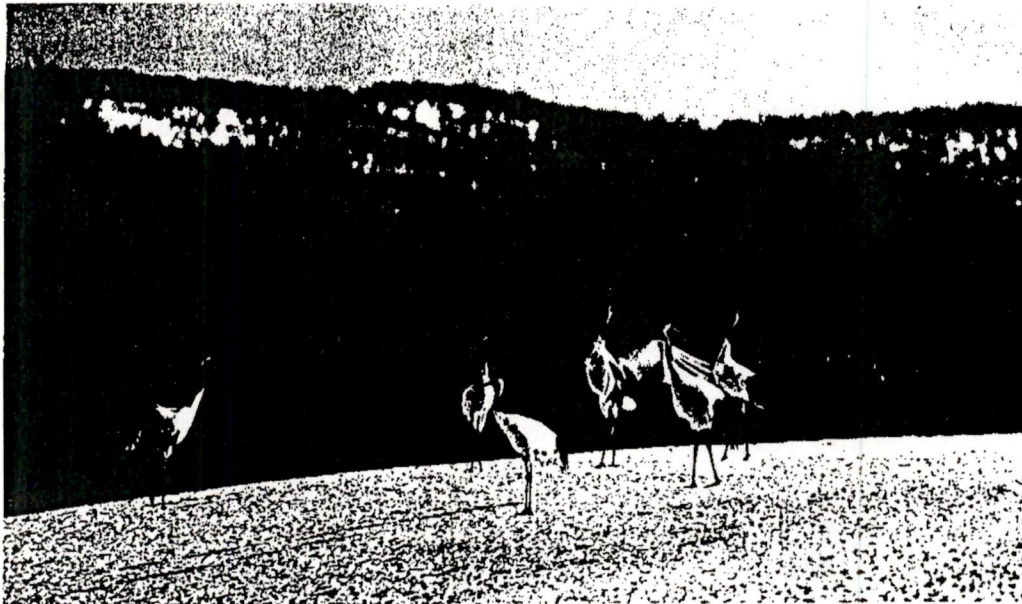
Despite being one of the most densely populated countries in the world with only 370,000 square kilometers, Japan possesses an abundant variety of flora and fauna that includes native species. Japan is home to 188 species of mammals, 665 species of birds, 87 species of reptiles, 59 species of amphibians, 200 species of fresh-water fish, approximately 29,000 species of insects, and approximately 8,100 species of plants. This rich diversity surpasses that of other regions of this latitude.

Wildlife Protection — Government Measures

Considering that 75% of its bird species is migra-

tory, Japan recognizes that protection requires international cooperation. In this regard, Japan has concluded a protective treaty on migratory birds involving the United States, Russia, China, and Australia, and promotes various measures and joint research efforts to protect avian wildlife. As a Contracting Party of the Convention on Wetlands of International Importance especially as Waterfowl Habitat, Japan has established four wetlands to date: three in Hokkaido and one in Miyagi Prefecture. These are registered wetlands, according to the guidelines of this convention.

Efforts to protect endangered animal and bird species and increase their populations are being actively promoted. Special projects for animals include the provision of winter feeding for and monitoring of the Iriomote wildcat and the Tsushima wildcat. Efforts related to bird species include the provision of winter feeding for the Japanese crane and the Shima owl, artificial nest boxes for the Shima owl, and maintenance of the growth environment for the albatross.



Wild Bird Society of Japan

Tsurui-Ito Tancho Sanctuary managed by the Wild Bird Society of Japan

Through these efforts, the Japanese crane population has risen to approximately 550, a clear recovery from the time when there were fewer than 100 cranes.

Japan also provides support to developing countries for the maintenance of the natural environment and the adequate management of natural resources. Typical projects have included the dispatch of experts to a Kenyan wildlife public corporation, the planning of a park based on the protection of chimpanzees living in the Tanzania National Park, support for a study on the protection of river dolphins in the Yangtze River, and cooperation with China in the protection of the Japanese crested ibis and of the panda.

Wildlife Protection—Public Measures

Grass-roots activities related to wildlife protection have become very widespread. Various private conservation groups purchased land through the National Trust Activities in order to protect animal and plant habitats from the encroachment of cities and housing developments. To cite an example,

one conservation group purchased a dragonfly habitat, which it calls the Dragonfly Kingdom, in Kochi Prefecture to ensure the dragonfly's survival. Another organization has established a nature observation center at the Utonai lakeside in cooperation with the local municipality, and the Tsurui/Ito Japanese Crane Sanctuary has been established in Tsurui village, Hokkaido, to protect wetlands that provide a home to the Japanese crane.

Protection through the Observance of International Agreements

To further demonstrate its support for the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES), which prescribes international trade rules on wildlife, in January 1992 Japan withdrew its special reservations on bengal monitors, yellow monitors, and olive ridleys, and adopted a policy of banning the import of hawksbill turtles after 1993, to be followed by a withdrawal of its special reservation by July 1994. The import of processed and unprocessed African elephant products had



Environment Agency

The Japanese crested ibis

already been banned prior to CITES, which prohibited such commercial trade in 1990.

In addition to such steps, the government of Japan invited the 8th meeting of the Conference of the Parties to CITES to Kyoto in March 1992 for the purpose of further contributing to international cooperation on wildlife protection. Carefully prepared for and coordinated by Japan as the host country, the meeting was concluded very fruitfully. Japan has also extended an invitation for June 1993 to the 5th Conference of the Parties to the Convention on Wetlands of International Importance especially as Waterfowl Habitat.

To contribute to the achievement of effective conservation and management of whale resources by the International Whaling Commission (IWC), Japan, as a Contracting Party of the International Convention for the Regulation of Whaling, is conducting scientific research on minke whales in accordance with procedures stipulated in the Convention.

This research includes the taking of 300 minke whales in the Antarctic Ocean for a sampling survey designed to collect biological information on the reproductive mechanism of the whales that cannot be obtained through sighting surveys, and which is indispensable to the conservation and management of whale resources.

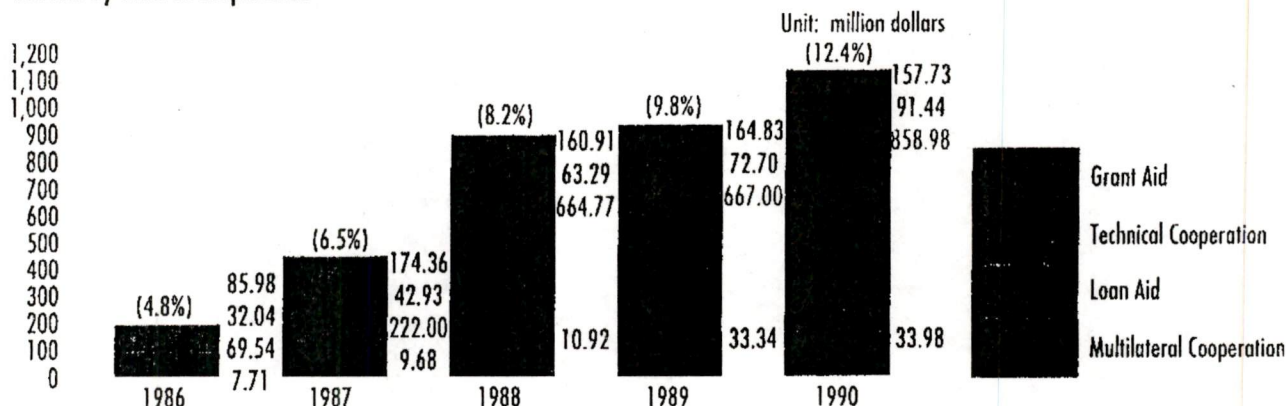
The sampling survey does not adversely affect the minke whale resources in the Antarctic Ocean. The IWC has estimated that the current population is plentiful, comprising approximately 760,000 whales. This estimation is based on calculations made by scientists using data from sighting surveys in the Antarctic Ocean in which Japan fully assisted.

Support for Developing Countries

Strengthening international cooperation to provide people in developing countries with a better life and to protect the environment

• Japan's Cooperation in the Environmental Field

Results by form of cooperation



Notes: () of a total column is the ratio compared with the entire Japanese ODA.

Each yearly total was converted into dollars based on the following DAC indication (fiscal year):

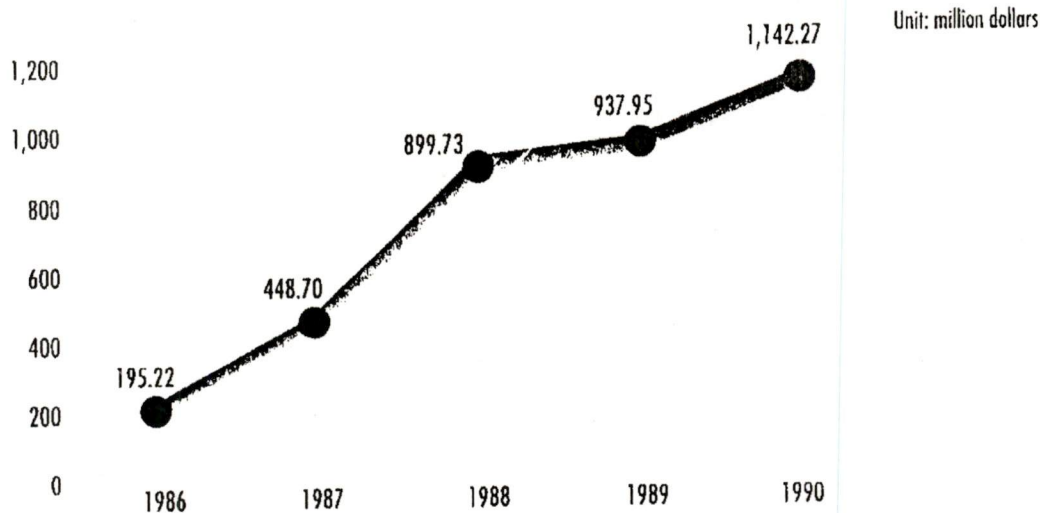
DAC conversion rate: '86=168.52; '87=144.64; '88=128.15; '89=137.96; '90=144.80

Basic Concepts

Global environmental problems should be tackled with cooperation and collaboration between the developed and the developing countries. Japan will provide assistance by utilizing its wealth of experience in conserving the environment while achieving rapid economic growth. Here, importance will be placed on effectively and efficiently combining various aid plans geared to implementing projects in accordance with differences in levels of development and other conditions in each country. In addition, Japan continues to attach importance to cooperation in solving other issues such as poverty and high population growth which are closely linked with environmental problems, and to more rigorous environmental considerations in the preparation and implementation of aid projects.



The Environmental Research and Training Center in Thailand

Support for Developing Countries**• Changes in Japan's ODA Total Amounts in the Environmental Field**

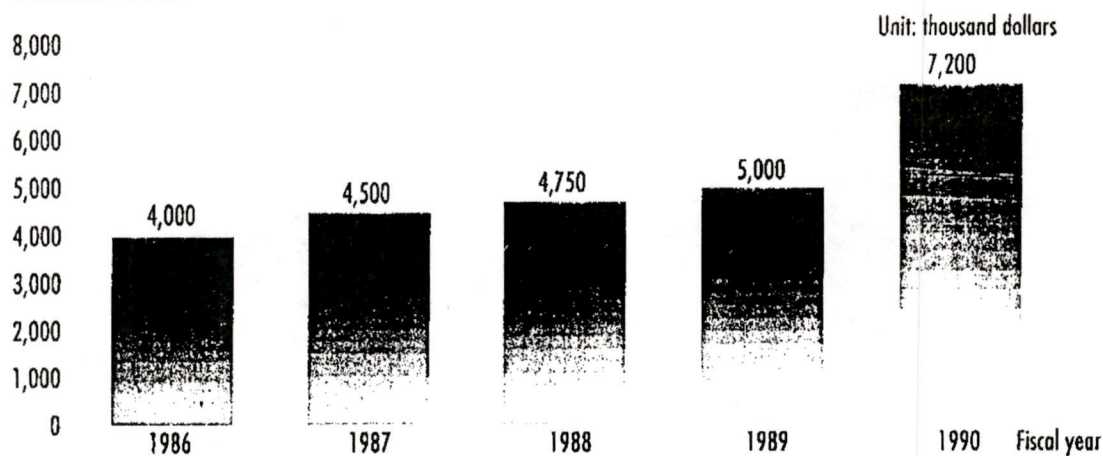
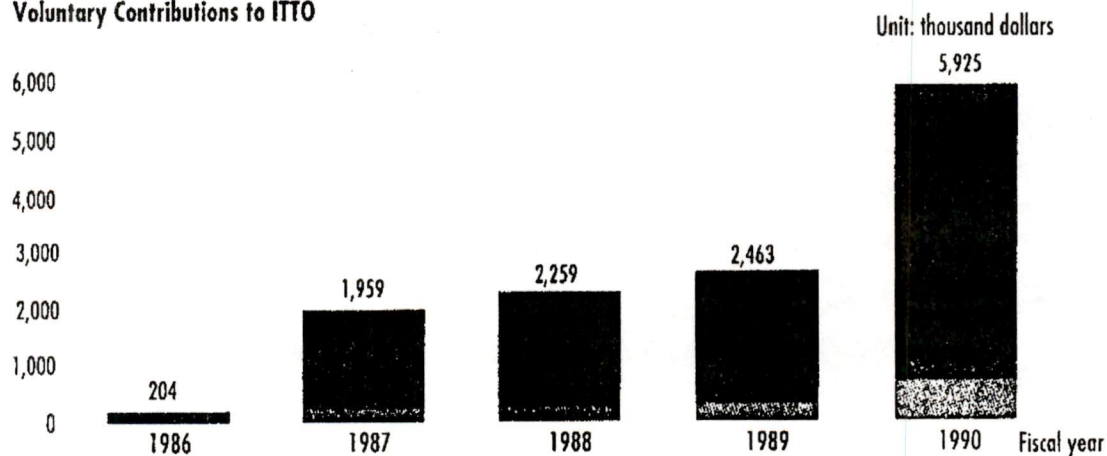
Note: Each yearly total was converted into dollars based on the following DAC indication (fiscal year):
DAC conversion rate: '86=168.52; '87=144.64; '88=128.15; '89=137.96; '90=144.80

Bilateral Support and Technical Cooperation—Cooperation with Air Pollution Control Measures

Using its vast experience and advanced techniques in anti-pollution measures and forestry conservation and afforestation, Japan assists developing countries in dealing with their environmental problems. One example is Japan's efforts to eradicate air pollution in Mexico City, where over 3,000,000 vehicles and approximately 30,000 factories have created an untenable situation. From 1986 to 1989, Japan has been engaged in air pollution studies in Mexico City and has assisted its citizens in combating this problem through technology-transfer seminars, the dispatching of experts, and the education of technical trainees in air pollution control. Over 69.3 billion yen was loaned in 1990 to equip oil refineries with desulfurization devices.

Cooperating in Desertification Prevention

The Project Team for Green Promotion and Cooperation, formed by Japan Overseas Cooperation Volunteers, has been assisting Senegal and Tanzania since 1986 and Niger since 1990 in the fields of forestry maintenance and development. To prevent desertification, Japan promotes reforestation projects such as nursery plantings as well as instruction in reforestation and agroforestry cultivation techniques that encourage the growing of food crops between these planted trees, so as to combine agriculture and forestry management and provide profits from both of these sources.

Support for Developing Countries**• Japan's Multilateral Cooperation****Donations to UNEP****• Japan's Multilateral Cooperation****Voluntary Contributions to ITTO**

Note: In 1989, an additional 20.132 million dollars was given in special voluntary contributions.

Support for Developing Countries

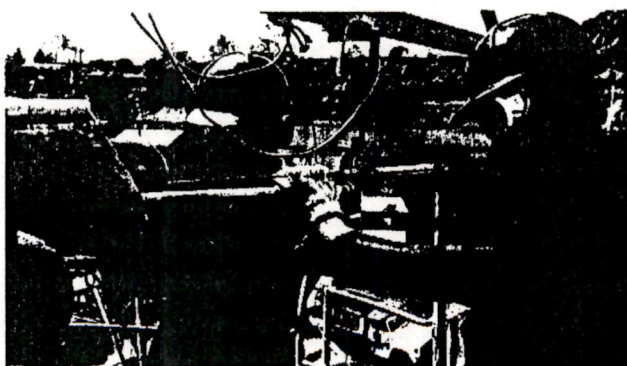
• Technical Cooperation

Unit: people

Fiscal Year				Project-Type Technical Cooperation		
	Trainees Received*	Experts Dispatched	JOCV	Project	Trainees Received*	Experts Dispatched
1986	167	103	48	14	33	124
1987	147	96	55	14	52	141
1988	150	129	59	14	41	142
1989	314	152	59	27	66	210
1990	669	194	54	30	72	241

Notes: Figures indicate new and continuing personnel.
* are results by group course.

Source: "Japan's ODA," Ministry of Foreign Affairs



Mexico City's air pollution survey carried out jointly by the Japan International Cooperation Agency (JICA) and Air Conservation Bureau of the Urban Development and Environment Ministry (SEDUE)

The Dispatching of Experts and the Trainee Programs

Japan has aggressively expanded assistance to developing countries by establishing an environment center that plays a major role in dealing with the environmental problems of the developing nations. Experts have been sent and many people trained to cope with their country's environmental problems. A training center for environmental studies in Thailand and an environment maintenance center in cooperation with China are two examples of ongoing efforts undertaken by Japan.

Japan's policy announced at the 1989 Arhc Summit to provide 300 billion yen in environment aid from 1989 to 1991 was already nearly fulfilled by 1990. At the London Summit of 1991, Japan again demonstrated its concern for the environment by announcing its basic concepts and designating important areas for future support.



JICA

Crude oil spills in Saudi Arabia caused by the Gulf War, cleaned up by the Japan Disaster Relief Team with oil skimmers

Multilateral Support

Japan actively contributes to various international institutions dealing with the resolution of global environmental problems. In 1989, Japan hosted the Tokyo Conference on the Global Environment and Human Response toward Sustainable Development in cooperation with the UNEP. Additionally, Japan, as a sub-chair nation, has contributed to the preparation of the United Nations Conference on Environment and Development (UNCED) by sending two Japanese staff members to the UNCED secretariat.

An invitation to establish the UNEP International Environmental Technology Center in Japan has been extended to the UNEP, and support will be given to transfer environmental management technologies to the developing countries and those with economies in transition by means of providing training and consulting services, carrying out research, and accumulating and disseminating related information in cooperation with other organizations.

As part of the international effort to repair large-scale environmental destruction caused by the Gulf War, Japan has provided oil fences and skimmers to clean up crude oil spills. An international emergency support team was dispatched to help in the recovery of crude oil. Further support was provided by an investigating commission on environment, health, and medicine, as well as a sea-water/fresh-water facilities maintenance team.

THE WHITE HOUSE
WASHINGTON

DATE: June 3, 1992

DCF HAS SEE

TO: Sec. Skinner

FROM: **CLAYTON YEUTTER**
Counsellor to the President for
Domestic Policy



Sam, for your info. These
are the negotiating instructions
we provided to Reilly.



THE WHITE HOUSE

WASHINGTON

IN

June 1, 1992

MEMORANDUM FOR WILLIAM K. REILLY
ADMINISTRATOR
ENVIRONMENTAL PROTECTION AGENCY

FROM: CLAYTON YEUTTER
ROBERT B. ZOELICK

SUBJECT: UNCED - RIO CONFERENCE

To assist your work in Rio, this memorandum is intended: (1) to outline positions the United States should advocate on issues that we know to be outstanding; (2) to note additional issues that may arise; and (3) to indicate, particularly for public diplomacy purposes, specific contributions the United States has made in the UNCED process.

I. Outstanding Issues

A. Rio Declaration

We have four problems with the text as drafted:

- Principle 3 on the right to development
- Principle 7 on responsibility and guilt
- Principle 12 on trade sanctions
- Principle 23 on people under occupation.

Our two most significant problems are:

- The right to development, because it undermines our traditional emphasis on human rights by suggesting the "right" to development is equivalent to civil and political rights. (For example, the PRC uses this argument to justify abhorrent acts.)
- The language on responsibility is silent about developing countries' responsibilities and could be used later to argue that "responsibility" means legal liability.

The "trade sanction" issue is important, but we may need to evaluate whether to hold out because of this item. We are, in effect, defending our unilateral ability to press environmental positions through our trade laws. (We could

be in the ironic position of being attacked for resisting this "environmental" declaration because of language implicitly criticizing us for unilateral action to protect species.)

An increasing number of countries want to accept the draft as it is.

- This includes the EC and the G-77, which have said they will not reopen the draft text if no one else does.

You will need to seek out key conference leaders, in particularly Tommy Koh and appropriate Brazilian officials, to make our concerns known.

We can't accept the draft as it is currently written but could with minimal changes. (Delegation staff have the minor changes we need.) Making those changes quietly, behind the scenes, without fully reopening the debate would be the preferred outcome. Should that not prove feasible, based upon your discussions with Ambassador Koh, please confer with us again. Should the negotiations be fully reopened, we may wish to seek additional changes in the text. We will discuss those with you at that time. This issue merits close coordination since it will be especially sensitive in Rio.

B. Forests

The United States should seek to focus as much attention as possible on this issue:

- It's a subject that people understand--can see and touch. (And the public associates Brazil with forests.)
- The United States has a strong domestic record that we should promote.
- Our international position as the leading proponent of a strong statement of principles on forests leading to a convention (see below) puts us on the high ground, and the completion of the GCC treaty and GEF arrangements answers LDC excuses for delaying action.
- POTUS's initiative will give us momentum and further back our words with deeds (as compared with documents on biodiversity that others will point to).

- Forests are also a positive (and practical) response to concerns about CO2.

You know that we are committed to a strong statement of principles on forests and a commitment to negotiate a legal binding convention. Much work remains on this issue.

- In the Kuala Lumpur Declaration, the G-77 state their opposition to negotiating a legally binding convention.
- Most of the conservation/management principles are in good shape. We should not allow them to be watered down; we have the record and (now) even a financial commitment, so we should hold the policy high ground, urging NGOs to support us, including publicly.
- We need to counter G-77 efforts to exploit cross-cutting issues like financial, technology, intellectual property, and the "right to development" in the forest principles.
- Our positions on finance, technology transfer and intellectual property rights need to be consistent with positions set forth elsewhere in this paper.

We need to work to get POTUS the most credit for his forest initiative.

- We will work with the NSC to send out letters to G-7 Heads in advance of POTUS's announcement.
- Our goal should be to secure G-7 (and other) support by the time POTUS speaks in Rio, so he can follow up his announcement by stating we have others on board.

C. Financial Resources

There is currently no agreed text on this critical issue.

- At Prepcom IV, Ambassador Rosenthal of Mexico sought to engineer a potential compromise document that appeared promising before the G-77 backed away from it.
- If the Kuala Lumpur Declaration is an indication, the G-77 will seek to begin negotiations from their original text. (We cannot work off the original G-77 text, and they are aware that agreement will not be possible on that basis.)

Related to financial resources are the sections in each Agenda 21 Chapter entitled "Means of Implementation," which

contain cost estimates.

- We will need to ensure that these sections at most only reflect order-of-magnitude estimates and that they do not imply a commitment to fund.

D. Biodiversity

The Biodiversity Convention creates substantial problems for the United States. Our three most important problems are in the areas of:

- Intellectual property rights/technology transfer
- Finance (especially the relationship between the GEF and the convention)
- Biotechnology.

Our positions on intellectual property rights/technology transfer and finance need to be consistent with the positions set forth elsewhere in this paper. (The IPR provisions in the Convention are out of touch with developments in the world economy--Economic Ministries in LDCs have learned long ago that "mandatory transfer" provisions make no one better off.)

On Biotechnology we need to resist efforts to incorporate broad-based regulation of biotechnology into Agenda 21.

- We won't stifle a leading competitive industry for the United States just as it is being launched.
- Biotechnology has the potential to create enormous good for mankind.

As you know, we released on May 29 a statement explaining our opposition to this treaty. It also cites facts about our support for biodiversity through deeds. Our forestry initiative can be used to resonate this point.

We should resist reopening these negotiations in Rio unless and until there are very strong indications that the delegates will accommodate to our position on all three of the major issues listed above. There is already a lot of other language in this convention that we find objectionable; it is simply not in the "deal breaker" category. Even if the financial arrangements could be handled in a satisfactory way, we have so much interest in biotechnology and intellectual property that we cannot run the risk of signing an agreement that would be unacceptable

in either of these areas.

Our present assessment is that we should devote our time and attention to other issues in Rio, while emphasizing that we have already accomplished a great deal in this subject matter area. In other words, there is no need for us to be defensive on biodiversity. Our concern is not with the biodiversity commitments of the draft convention, but with the extraneous obligations that have regrettably been added.

E. Technology Transfer/Intellectual Property

Serious issues remain at stake in the technology cooperation chapter of Agenda 21.

The G-77 is seeking to have industrialized countries promote the transfer of technologies to developing countries on specific terms more favorable than market terms.

- Such proposals are unacceptable to us. They purport to place developing country needs above intellectual property protection (we have been fighting this concept in the Uruguay Round and elsewhere).
- Although the other OECD countries agree with us in substance, they are much more carefree about language.

We will need to be extremely rigorous on this issue, as it is one of the areas most likely to come back to haunt us in future negotiations.

F. Oceans

We are in good shape on the oceans issues.

We promoted proposals on key areas (controlling land-based sources of pollution, protecting living marine resources and conserving coastal areas) which were accepted and form the heart of the oceans chapter of Agenda 21.

There is one outstanding issue: straddling stocks.

- We acted as an honest broker to help Canada by agreeing to a conference on high seas fisheries.
- We want the EC to accept this compromise but will not go along with EC efforts to cover fisheries within our 200 mile EEZs.

G. Status of Agenda 21

Approval of Agenda 21 is not, in the U.S. view, a commitment to implement/fund every activity that it contains.

Rather, we view Agenda 21 as a "menu of options" from which governments will select appropriate activities based on their priorities and means at their disposal.

The draft introduction to Agenda 21 contains language to the effect that it will be carried out "according to the different situations, capacities and priorities of countries and regions."

-- At a minimum, we need to ensure that this language is retained.

H. Military

There were repeated attempts at Prepcom IV to insert references to military activities in UNCED documents.

The fundamental problem is that some of these references would create implications that peacetime environmental principles should also apply to military activities during wartime.

We will need to avoid any such implication and ensure that any language referring to the military is closely coordinated with the DOD representative on the delegation.

I. Other Issues

We have some important elements to offer: (1) GEF for global issues; (2) greater IFI attention to environmental topics, or economic projects with environmental externalities (energy pricing); (3) IDA X "Earth Increment" for other multilateral projects; (4) "new and additional" language (as interpreted through cleared guidance); and (5) a long list of our bilateral efforts. (Suggest you prepare a handout with examples.)

We will need to hold our positions on several unresolved issues:

-- No new "Green Fund."

-- Resist pressure, which may even come from within the G-7, to seek to achieve the UN target for ODA (0.7 percent of GDP). The United States has never accepted an ODA target. (Currently, U.S. ODA is about 0.23 percent of GDP.) ODA is not an "entitlement" -- we

need to retain freedom to reallocate -- including for environmental projects -- to meet the new needs of the post-cold War world.

- No implication that "new and additional" means above and beyond any particular level of ODA.
- Resist implication that "new and additional" means above and beyond any particular level of ODA.
- Resist pressure from the G-77 to commit to quantitative amounts of funding, for example with respect to the IDA X replenishment.
- Ensure that the description of the GEF as an available financial mechanism comports with the agreements reached among the GEF participants last month. (Note: The Biodiversity Agreement would change the agreed "governance" provisions of the GEF, and that's one reason for our position.)

We will also want to promote: the development of national strategies that integrate environment and development; the role of the private sector; the importance of domestic economies that encourage robust free markets and free trade; and the need for innovative ways and means of mobilizing resources.

J. Structure/Approval of Documents

There are at least two open questions regarding the overall handling of various UNCED documents: one on the inclusion or breakout of the chapters on financial resources and technology cooperation, and one on how the documents are to be approved.

With respect to the finance and technology chapters, our preference is that they remain part of Agenda 21.

The three texts being prepared for UNCED -- the Rio Declaration, Agenda 21, and the statement of forests principles -- will not be legally binding.

- As such, we expect they would be formally adopted by decision of the Conference, but not "signed."
- Signature is ordinarily reserved for legally binding treaties and conventions, for final acts of conferences or for communiques.

If strong interest in signing some additional document

develops, we could consider signing the final conference report or a Rio Final Act. If others call for a Head of State communique, you should seek to determine its scope and then review the issue with Washington.

- It is not uncommon for conferences to close with a Final Act that records the time, place and participants, of the meeting, and describes procedural fashion the various outcomes of the meeting.

It will be important for the final conference report to reflect fully all views that delegations may wish to make part of the official record.

- This was done in the Final Report of the Stockholm Conference.
- It is important for UNCED, given the sheer length of the documents and the breadth of the topics covered, the hurried nature of the negotiations, and the numerous compromises made in various points.
- This could be an important vehicle for us to use to note our interpretations/reservations regarding certain provisions in the Rio Declaration, Agenda 21 and other documents.

II. New Issues that May Arise

As you know from the G-7 Environment Ministers meeting, there may be attempts from within the G-7 to issue a declaration on climate change that includes commitments to targets.

- You should take the same approach as at the G-7 meeting, i.e., that such a declaration would be divisive, not helpful, and in our view contrary to a compromise that involved concessions on our part too.
- Our remarks on climate change could stress the rigorous nature of the process established by the new convention, point out that we are the one country that has prepared a detailed action plan noting effects, and call for others to pledge deeds (as we have), not just words.

Others may try to link their support for a forest convention with U.S. support for a desertification convention.

- We are not enthusiastic about such a convention and should try to avoid such a linkage.

- If necessary, we could agree to a conference on the subject of desertification, but we would not want such a conference linked to future activities related to forests.

III. U.S. Contributions

This is an illustrative list; you should make use of the Fact Sheets on individual issues for more detailed information and points.

Forests and oceans cover the preponderance of the Earth's surface, and the United States has actively promoted strong outcomes on both.

- On forests, the United States is clearly in the lead. We have pushed for a strong statement on forest principles and for a commitment to negotiation of a legally binding convention.
- On oceans, we have been the driving force behind the Agenda 21 oceans chapter.

We have highlighted the importance of public participation in environmental issues, including access to information and participation in environmental decision-making. We achieved the inclusion of a principle on this point in the Rio Declaration and in many parts of Agenda 21.

We have also stressed the value of environmental impact assessment and secured language in the Rio Declaration on this subject and in many parts of Agenda 21.

We played a major role in promoting the broad concept of technology cooperation and in shaping the Agenda 21 chapter on this subject.

We have emphasized the importance of controlling toxic substances and have pushed for strong language in that Agenda 21 chapter.

Our ideas on UN institutional reform, which stress more efficient use of existing resources and revitalization of ECOSOC, have driven consideration of this issue.

IV. Declaration Support

As you know, Buff Bohlen has coordinated our interagency efforts during the Prepcom process. He will continue to do so in Rio.

Mike Young, Bob Zoellick's Deputy, will be in Rio throughout the Conference and will be responsible for clearing positions/questions with the two of us.

We do not wish to constrain you and your delegation inordinately, for you must make most decisions on the scene, based on conditions to which you will be privy and we will not be. Nevertheless, any major policy questions should be cleared by either you or Mike with one of us.

Either of you should feel free to contact whichever of us is most readily accessible at any point during the conference.



DEPARTMENT OF THE TREASURY
WASHINGTON

May 27, 1992

ASSISTANT SECRETARY

MEMORANDUM FOR SAMUEL SKINNER/
CLAYTON YEUTTER
RICHARD DARMAN
EDE HOLIDAY

FROM: FRED T. GOLDBERG, JR.

Attached are materials relative to the modified enterprise zones proposal. We have made substantial progress along the lines discussed at our prior meetings. We need to reach closure on two technical issues within the context of the revised proposal, and three additional incentives that HUD is recommending.

The Senate Finance Committee has scheduled a hearing for next Wednesday, June 3, on enterprise zones. My understanding is that Nick Calio has agreed that the Ways and Means Republicans may introduce the revised proposal at the unemployment mark-up scheduled for this afternoon, with disclaimers regarding subsequent modifications.

Attachment

See 5/27

Hold/Meet
Kemp et al
on Monday.



DEPARTMENT OF THE TREASURY
WASHINGTON

May 27, 1992

ASSISTANT SECRETARY

The Honorable John C. Weicher
Assistant Secretary for Policy
Development and Research
Department of Housing and Urban Development
Washington, DC 20410

Dear John:

Enclosed are: an updated chart summarizing the enterprise zone proposal; draft statutory language; and a draft committee report. The statutory language and committee report will require fine-tuning as the proposal is refined. Please note that Parts IV and V of the bill (regulatory flexibility and foreign trade zone provisions) have been included as they appeared in the 1993 Budget proposal and should be reviewed in light of the current proposal.

The draft reflects an effort to provide effective tax incentives that will generate meaningful entrepreneurial activity in the zones and at the same time to assure that enterprise zones do not become havens for tax shelter activity that would undermine and discredit the program.

I believe that the draft reflects our discussions with two exceptions.

(1) Language relating to the "course of action" and HUD's authority to designate zones has been retained because of the important contribution local cooperation and involvement make to enhancing the effectiveness of the tax incentives provided in the statute.

(2) A rule netting enterprise zone gains and losses on an investor basis, rather than on an investment basis, has been retained because it appears to be the only administrable method of avoiding the economic distortions that would otherwise occur under the capital gain/ordinary loss provisions

We estimate the revenue cost of the proposal at approximately \$2.0 billion over five years, assuming that 125 zones are designated in the first year of the program. If, as a result of the practical constraints of the designation process, the zones are phased in over a three year period, the revenue cost would fall to approximately \$1.5 billion over five years. In determining the criteria for zone qualification, please keep in mind that the revenue effects of the proposal depend on the definition of a zone. Any substantial change in the demographics

of the average zone from the 1993 Budget proposal would require an entirely new estimation model.

HUD has proposed the adoption of several incentives in addition to the ones provided in the statute: (1) restoration of the stock expensing provision included in the 1993 Budget proposal; (2) passive loss relief for investors in enterprise zone businesses; and (3) a capital incentive for investment in plant and equipment. We recognize that these are basic policy issues. At the staff level, we have a number of policy and revenue-based concerns. Nevertheless, we understand that these options continue to be considered elsewhere in the Administration.

I look forward to further discussions of this matter in the future.

Sincerely,



Fred T. Goldberg, Jr.
Assistant Secretary
(Tax Policy)

ENTERPRISE ZONE PROPOSAL

The following chart compares the 1993 Budget's enterprise zone proposal and our recommended revisions to that proposal. The revisions broaden the scope of the program and deepen its incentives. They are intended to assure that all areas meeting objective criteria are eligible to participate in the program, and to promote the types of investment and entrepreneurial activity that are essential to revitalizing distressed urban and rural areas. In developing our recommendations, we have operated under the following policy and budget guidelines: (a) it is not appropriate to have substantial negative effective tax rates on zone investments; (b) certain types of tax shelter and inactive investments provide no meaningful improvement in the economic development of the zone or quality of life of zone residents; and (c) the revenue cost to the proposal should be in the range of \$1.8 billion over the 5-year budget period.

The modified proposal includes the following tax incentives, and covers all areas meeting objective criteria. Based on the anticipated criteria, approximately 125 areas will qualify for enterprise zone status.

- The proposal expands the definition of enterprise zone assets eligible for the 100% capital gains exclusion to include all intangible assets that are used in the enterprise zones business, such as goodwill and customer lists. These intangibles are the primary appreciated assets of businesses such as retail stores, service providers, and small manufacturers. Enterprise zone assets would include rental real estate leased to qualified enterprise zone businesses, and substantially renovated residential property. The holding period on qualifying real property would be extended from 2 to 5 years.
- The proposal makes all equity investments in qualifying enterprise zone businesses eligible for a 100% capital gains exclusion. The exclusion applies regardless of the amount invested and applies to any investor.
- The proposal treats losses on enterprise zone investments as ordinary losses, rather than capital losses. Ordinary losses may offset ordinary income, including earned income. No similar provision is included in the 1993 Budget.
- The proposal provides for tax-exempt bank and public financing of enterprise zone businesses. Such financing would be covered by existing volume cap rules and other provisions governing exempt facility bonds.
- The proposal excludes 100% of the gain on sale of a personal residence located in an enterprise zone up to \$200,000. No similar provision is included in the 1993 Budget.

The 100% exclusion for capital gains on all equity investments, ordinary loss treatment, and access to tax exempt financing replace the 1993 Budget's stock expensing provision. Although it might seem appealing to retain this incentive, it would result in a substantial negative effective tax rate (Attachment 1 demonstrates this consequence). It would also more than double the cost of the proposal over the 5-year budget period. Moreover, the alternative incentives we are recommending will be far more effective than expensing. A comparison of the expensing provision and our modified proposal is included as attachment 2.

Features	Budget Proposal	Revised Proposal
Number of EZs	50	Estimated at 125 (based on objective criteria)
EZ designation	Objective and subjective criteria	Objective criteria (any region meeting criteria qualifies)
EZ Business	• Active businesses and rental real estate • Substantially all assets and employees within EZ and relate to the business • No substantial intangible assets • Related party and integrated business limits - related parties aggregated for qualification as EZ Business	• Active businesses, real estate leased to EZ businesses and improved residential real estate • Same; in addition, at least one-third of employees must be zone residents • Intangible assets, (except for financial property in excess of working capital requirements) qualify if they are used in and related to the zone business; intangible assets that are used outside the zone do not qualify • None
Wage Credit	• 5% refundable wage credit for qualified employees of EZ Businesses	• Same
Financing Incentives	• None	• Tax-exempt financing for EZ Businesses
Exclusion of gain on sale of principal residence	• None	• Exclusion of capital gain (lifetime limit \$200,000) on EZ property that has been taxpayer's principal residence for 5 years

Investor Level Capital Incentives	• Expensing of \$50K/year (\$250K lifetime) for investment in small (\$5M assets) EZ Business; stock basis is reduced by amount expensed • Available only to individuals purchasing at original issuance • Business must have assets less than \$5M - benefits recaptured if business assets exceed \$5M • Business must be a corporation (S corp. does not qualify) • Eligible investment must be used to acquire assets qualifying for capital gains exclusion (described below) or to acquire inventory • Losses are capital and may only offset capital gains	• Exclusion of capital gain on investment in an EZ Business held for 2 years or more - no single investor limit • Available to all taxpayers regardless of how shares were acquired • No size limits • Any business form qualifies • Exclusion available to the extent EZ business could exclude gain if its assets were disposed of on date of investor disposition • Losses are ordinary and may offset earned income
Business Level Capital Incentives	• Exclusion of capital gain on tangible property used at least two years in any EZ Business • Losses are generally capital and may only offset capital gains	• Exclusion of capital gain on tangible property and qualified intangible assets used at least two years (five years in the case of real property) in an EZ Business; • Losses are ordinary and may offset earned income
Transition	Exclusion only for gain accrued during period of EZ program	• Same

Attachment 1

Comparison of Expensing with Capital Gains Exclusion

Expensing an investment is the economic equivalent of excluding all income from the investment, making certain assumptions regarding the rate of return (this is analogous to the relationship between deductible IRAs and "backloaded" IRAs). Allowing both expensing and exclusion of income results in a substantially negative effective tax rate. A simple example illustrates these principles.

Example. X, a 31% bracket taxpayer, invests \$250,000 for five years in real property. The investment is sold for \$402,627 reflecting a 10% pre-tax return.

Expensing. X has a deduction of \$250,000 resulting in cash benefits of \$77,500 leaving X with a net investment of \$172,500. X has a \$402,627 gain on sale of the real property (X's \$250,000 basis is reduced by the \$250,000 expensed). The tax liability resulting from the gain is \$124,814. X's net proceeds are \$277,813 on a net investment of \$172,500, or a 10% after-tax return. (Alternatively stated, if X invested his tax savings in the same manner, with the same tax consequences, he would end up with total net proceeds of \$402,627 on his initial \$250,000 investment, or an after-tax return of 10%.)

Exclusion. X pays no tax on its investment, its pre-tax return is its after-tax return, 10%.

Combination expensing and exclusion. There would be a significant negative tax rate if X were allowed to expense its \$250,000 investment and exclude the \$402,627 gain from the asset's sale. If both benefits were available, after-tax, X would have a net investment in the real property of \$172,500 and a return of \$402,627. X earns an 18.5% after-tax return from an asset with a 10% pre-tax return. This is equivalent to a negative 85% tax rate applied to X's investment.

Attachment 2

Comparison of Expensing Provision and Modified Proposal

Expensing Provision

Dollar limits: \$50,000
per year/ \$250,000
lifetime

Only individuals eligible
for expensing

Expensing only for
investments in C
Corporations (i.e.,
partnerships, S Corps
and proprietorships
not covered)

Expensing available only
to original purchasers,
not subsequent buyers

Expensing subject to
recapture if business
assets exceed \$5 million
at any time

Strict related party and
integrated business
limitations

Losses treated as
capital losses, off-
setting only capital
gains

No access to tax
exempt financing

Modified Proposal

No dollar limits on
investments eligible for
100% capital gains
exclusion

All types of investors
eligible for 100%
capital gains exclusion

All forms of investment
eligible for 100% capital
gains exclusion --
permits investment in
entities that flow
through tax losses and
impose single level tax

Subsequent purchasers, as
well as original
investors, eligible for
100% capital gains
exclusion

No size limit on
businesses eligible for
100% capital gains
exclusion

No related party and
integrated business
limitations

Losses treated as
ordinary, off-setting
ordinary income

Access to tax exempt
financing

**EXAMPLES ILLUSTRATING DIFFERENCES BETWEEN
THE 1993 BUDGET ENTERPRISE ZONE
PROPOSAL AND THE REVISED PROPOSAL**

The following examples illustrate the consequences of broadening and better targeting enterprise zone tax incentives in the context of a range of zone activities.

Example 1. Local Retail Business. Mr. and Mrs. Grocer invest \$50,000 to establish a small grocery business (in corporate form). The business uses \$25,000 of the contribution to acquire inventory. The remainder is used for rent, other overhead expenses and the wages of a delivery person. After four years of growth and an expanding clientele, Mr. and Mrs. Grocer sell their business for \$250,000, \$225,000 of which is attributable to "goodwill" and a customer list they have developed through their grocery delivery service, \$25,000 is attributable to inventory (with a \$25,000 basis).

	Summary	
	<u>1993 Budget Proposal</u>	<u>Revised Proposal</u>
Initial investment	\$50,000	\$50,000
Less tax benefit of expensing (31% of \$25,000)	<u>7,750</u>	<u>0</u>
Net cost	\$42,250	\$50,000
 Sale price	 \$250,000	 \$250,000
Adjusted basis	<u>25,000</u>	<u>50,000</u>
Taxable gain	\$225,000	\$200,000
Tax rate on gain	.31	.0
Tax on gain	\$69,750	\$0
After-tax proceeds	\$180,250	\$250,000
 Up-front tax benefits	 \$7,750	 \$0
Back-end tax benefits (cost)*	(\$13,750)	\$56,000

* Consists of \$7,500 recapture tax plus 3% of actual appreciation (difference between 28% and 31% rates)

Notes:

1. Under the 1993 Budget Proposal:

- (a) In order to expense the \$25,000 the Grocers must operate their business through a C corporation. As a result, they could not use any corporate losses to offset their other income; any profits would be taxed at the corporate level, and then taxed again as dividends if distributed; and, as a practical matter, a purchaser of the business could not write-off any of its acquisition costs.
- (b) Expensing of the initial \$50,000 of capital is limited to \$25,000 because only that amount was invested by the corporation in tangible property.
- (c) Because they elected expensing, the entire \$225,000 gain realized on a sale of the corporation's stock is fully taxed as ordinary income. Because none of the gain is attributable to tangible property, if the corporation had sold its assets, all of its gain would be subject to tax.
- (d) If the corporation had not been successful, the Grocers would be entitled to a capital loss on the remaining \$25,000 unrecovered investment, and the loss could offset only capital gains (i.e., it could not be used to offset earned income).
- (e) A purchaser of the Grocers' stock may not expense any portion of the purchase price.
- (f) The corporation would not be eligible for tax-exempt financing.

2. Under the Revised Proposal:

- (a) The Grocers may conduct their business in any form (i.e., a C or S corporation, partnership or proprietorship). As a result, any losses incurred by the business may be used to offset their other income; any profits are taxed only once; and purchasers could write-off their entire acquisition costs over not more than 14 years (assuming enactment of the pending intangibles legislation).
- (b) Someone purchasing stock from the Grocers would also benefit from the 100% capital gains exclusion if the stock continues to appreciate in value.

- (c) If the business had not been successful, the Grocers could deduct their entire \$50,000 loss against other income.
- (d) The business would be eligible for tax-exempt financing.

An identical wage credit is available to employees of Mr. and Mrs. Grocer's business under both proposals. The same analysis applies to franchisees operating outlets in a zone (e.g., Burger King, 7-Eleven) on the sale of their franchises.

Example 2. Small Manufacturer. Mr. Enterprising persuades Mr. Success to invest \$3 million in a newly formed small manufacturing corporation that operates exclusively in the zone. The corporation uses the contributed capital to purchase machinery and equipment necessary to its operations. Six years later Mr. Success sells his stock for \$5 million.

Summary

	<u>1993 Budget Proposal</u>	<u>Revised Proposal</u>
Initial investment	\$3,000,000	\$3,000,000
Less tax benefit of expensing (31% of \$250,000 over 5 years)	<u>77,500</u>	<u>0</u>
Net cost	\$2,922,500	\$3,000,000
Sale price	\$5,000,000	\$5,000,000
Adjusted basis	<u>2,750,000</u>	<u>3,000,000</u>
Taxable gain	\$2,250,000	\$2,000,000
Tax rate on gain	.31	.0
Tax on gain	\$697,500	\$0
After-tax proceeds	\$4,302,500	\$5,000,000
Up-front tax benefits	\$77,500	\$0
Back-end tax benefits (cost)	(\$137,500)	\$560,000

Notes:

1. Under the 1993 Budget Proposal:

- (a) Although Mr. Success invested \$3 million up front, his expensing is limited to \$50,000 per year, and only \$250,000 may be expensed over his entire lifetime. Because expensing was elected, the entire \$2,250,000 gain realized on a sale of the corporation's stock is fully taxed as ordinary income.
- (b) If the corporation had not been successful, Mr. Success would be entitled to a capital loss on the remaining \$2,750,000 unrecovered investment, and the loss could offset only capital gains (i.e., it could not be used to offset earned income).

2. Under the Revised Proposal:

- (a) The small manufacturing business may be conducted in any form (i.e., a C or S corporation, partnership or proprietorship).
- (b) Someone purchasing stock from Mr. Success would also benefit from the 100% capital gains exclusion if the stock continues to appreciate in value.
- (c) If the business had not been successful, Mr. Success could deduct his entire \$3 million loss against other income.

Example 3. Improved Residential Rental Property. Ms. Apartment Owner purchases dilapidated property in the zone for \$100,000 and spends another \$900,000 to rehabilitate the property. After several years of renting the property, the property is sold for \$2 million, 90% of which is deemed to be attributable to Ms. Owner's rehabilitation.

Under the 1993 Budget Proposal, the \$1 million gain on the sale of a building used in a residential rental business is fully excluded from gross income.

Under the Revised Proposal, rental real estate is generally not eligible for tax benefits. However, because Ms. Apartment Owner's property is residential real property and she substantially rehabilitated the property, the capital gains exclusion is available to her to the extent the gain on disposition is attributable to the rehabilitation. In this case, 90% of the gain is excluded from gross income.

Example 4. Subsidiary of Non-Zone Corporation. An

international manufacturer seeks to establish a wholly-owned subsidiary to run an assembly plant in a zone.

Under the 1993 Budget Proposal, a business could be a qualified enterprise zone business only if substantially all of its sales, property and employees are located in the zone. For purposes of applying this test, activities conducted by persons related to the zone business are treated as part of a single business. Thus, because the manufacturer and its subsidiary would be treated as a single business, the subsidiary would not meet the conditions for being a qualified enterprise zone business.

Under the Revised Proposal, whether a business is an enterprise zone business is not determined with regard to the activities of related persons. Consequently, so long as the subsidiary independently meets the requirements, it will be eligible for zone tax benefits.

Example 5. Commercial Rental Property. Mr. Owner has a deteriorated warehouse in the zone worth \$300,000 (tax basis of \$200,000) immediately prior to zone designation. The warehouse is occasionally leased as storage space for equipment of businesses that are not operating in a zone. Mr. Owner has no employees in the zone. Property values rise as a result of zone designation. Two years later, Mr. Owner sells the property for \$500,000.

Under the 1993 Budget Proposal, Mr. Owner could exclude \$200,000 of his gain (the gain that accrued during the operation of the warehouse as an enterprise zone business) from gross income.

Under the Revised Proposal, the rental of commercial real property may qualify as an enterprise zone business only if the property is operated by a lessee in connection with the lessee's conduct of an enterprise zone business. Because Mr. Owner does not satisfy this requirement, all of his gain is subject to tax.

This same analysis applies to an investor who acquires the warehouse and sells limited partnership interests in it, a common arrangement for tax shelters.

Example 6. Intangible "Warehouse". Ms. Inventor has developed a number of patents and has a number of potentially patentable concepts for industrial chemical processes. Ms. Inventor has no significant tax basis in the patents and concepts. Ms. Inventor contributes the patents and concepts to a newly-formed C corporation located in an enterprise zone. The corporation enters into a development agreement with another corporation owned by Ms. Inventor. A number of the patents result in commercially marketable products and the patents are

sold by the corporation for \$3 million.

Under the 1993 Budget Proposal, the \$3 million gain is fully taxable because the proposal does not apply to intangibles. Under the revised proposal, the \$3 million gain is also fully taxable because the proposal does not cover patents under the circumstances described.

Establishment of Enterprise Zones

Present Law

In general, the Internal Revenue Code does not contain rules that target specific geographic areas for special Federal income tax treatment. Within certain Code sections, however, specific geographic areas are targeted for limited purposes. For example, the provisions relating to qualified mortgage bonds (section 25) define targeted areas for the purpose of promoting housing development within economically distressed areas. Similarly, certain geographic areas are designated as high cost or difficult to develop for purposes of the low-income housing credit (section 42), and an increased rate of credit applies to these areas. In addition, favorable Federal income tax treatment is provided for certain U.S. corporations that operate in Puerto Rico, the U.S. Virgin Islands, or a possession of the United States as a means to encourage the conduct of trades or businesses in these areas (section 936).

Certain Code sections also provide tax benefits specifically designed to benefit economically disadvantaged persons. The targeted jobs tax credit (section 51) provides an incentive to employers to encourage the hiring of individuals who are certified as members of specified historically under-employed groups. The earned income tax credit (section 32), provides relief for low-income wage-earning families.

Reasons for Change

Economically distressed urban and rural areas have been characterized by low rates of investment, job creation and economic growth. Although the economic distress has many causes, a significant contributing factor has been the shortage of investment capital entering into the areas and the flight of local capital from the areas. The perceived business risks associated with investment in distressed areas, which increase the cost of capital and depress the rate of investment, are also a contributing factor. If capital can be attracted to the areas, it is believed that the resulting increase in entrepreneurial activity will create new jobs, particularly for disadvantaged workers and long-term unemployed individuals, and increase the availability of goods and services to residents within the areas. Ultimately, this activity will help to alleviate the economic distress in the areas.

To encourage this increase in entrepreneurial activity, a series of Federal income tax incentives will be made available with respect to areas designated as "enterprise zones." Areas will be designated as enterprise zones based on the application of objective criteria designed to measure an area's distress. The incentives are intended to promote capital investment in businesses that will contribute to the long-term revitalization of these areas. In particular, the incentives focus on the

extent to which investment encourages equity ownership by local residents, increased availability of local goods and services, employment of chronically unemployed and disadvantaged individuals, and economic revitalization through meaningful entrepreneurial activity. The geographically targeted tax incentives are designed to overcome the perceived risks and high cost of capital associated with investment in these areas.

It is believed that the economic growth that will result from increased entrepreneurial activity in targeted areas will lead to benefits for the entire economy.

Explanation of Provision

a. Designation of enterprise zones

An enterprise zone may be either an urban or rural geographic area meeting specified objective criteria. Different criteria are provided for urban and rural areas. In addition to satisfying the objective criteria, the area must be nominated by the State or local government(s) with jurisdiction over the area. Any nominated area satisfying the objective criteria is entitled to be designated.

To be nominated, an area must be located wholly within the jurisdiction of qualifying State or local government, have a continuous boundary and minimum population, and evidence economic

distress through unemployment rates, poverty rates, and below-median-income or population loss statistics. In addition, the nominating State of local government(s) must meet specified objective conditions relating to their commitment to a course of action that will encourage economic revitalization of the area.

b. Enterprise zone businesses

Enterprise zone businesses, their employees, and their owners and creditors are eligible for enterprise zone tax incentives.

An enterprise zone business is an actively conducted trade or business that has a significant business presence in the zone. A trade or business does not have a business presence in the zone unless at least 80 percent of its annual gross income is derived from, and substantially all of its property and employees are directly involved with, the conduct of the trade or business in the zone. In addition, at least one-third of its employees must be enterprise zone residents. The rental of real property qualifies as an enterprise zone business only if the real property is leased to an enterprise zone business or is residential real property located in the zone that has been substantially improved by the business.

In order for a trade or business meeting the foregoing income, property and employee tests to have a business presence

that is significant, the Federal tax benefits resulting from treatment as an enterprise zone business must be commensurate with the contribution of the business to encouraging equity ownership by local residents, increasing the availability and delivery of local goods and services, employing chronically unemployed and disadvantaged individuals, and revitalizing the zone through meaningful entrepreneurial activity.

Certain activities are deemed not to contribute sufficiently to the local economy to constitute a significant business presence. Businesses holding patents, copyrights, trademarks, and other similar assets that are not exclusively related to use in and for an enterprise zone, businesses renting personal property to customers outside a zone, businesses whose activities are conducted by, or for the benefit of, a government, and businesses more than 50 percent of whose assets are financial property are not enterprise zone businesses. For this purpose, financial property means stock, securities, options, futures, notional principal contracts, forward contracts, foreign currencies, annuities and similar items.

The Secretary will prescribe regulations necessary to assure that tax benefits are available only to persons that contribute to the purposes of the Act. These regulations will provide factors for determining whether tax benefits are commensurate with the contribution of the business to the economic

revitalization of the enterprise zone. It is expected that the contribution of the business will generally be measured by the extent to which the business encourages ownership by zone residents, employs disadvantaged and long-term unemployed zone residents, increases the availability and delivery of goods or services within the zone and contributes to the revitalization of economic activity in an enterprise zone through meaningful entrepreneurial activity. A business need not satisfy all of these criteria to establish that it has a significant business presence; moreover, the weight given to each factor may vary, depending on the particular facts and circumstances. In general, it is expected that, in the absence of circumstances indicating potential tax benefits that are unusual for a traditional operating business, a bona fide business satisfying one or more of the above criteria would qualify as an enterprise zone business. These principles are illustrated by the following examples.

Example 1. A and B establish a small grocery business, X, in an enterprise zone with their own capital. X's assets consist of inventory, fixtures and a small working capital fund. Virtually all of X's gross income comes from the sale of groceries to customers residing in and around the zone. A and B work exclusively in the store and employ a delivery person. X meets the significant business presence test because it represents the development of local entrepreneurship and

increases the availability of goods and services in the zone. Moreover, X's assets and operations are not of a type that would produce unusual tax benefits in the context of a traditional operating business. Therefore, its potential tax benefit is commensurate with its contribution.

Example 2. C, a zone resident, persuades D, an investor living outside the zone, to contribute \$3 million to Y, a newly-formed small manufacturing business located in the zone that produces items designed by C. C retains a substantial equity interest in Y. More than half of Y's employees are zone residents. Y's products are sold primarily outside the zone. Y satisfies the significant business presence test because it represents the development of local entrepreneurship and provides significant employment opportunities for zone residents. Moreover, there are no unusual circumstances that result in the potential tax benefits to Y or its investors exceeding benefits commensurate with Y's contribution.

Example 3. E, a non-zone resident, purchases dilapidated property in the zone for \$100,000 and spends another \$900,000 to rehabilitate the property. E then rents the property to current zone residents, a substantial portion of whom are disadvantaged. E's rental business satisfies the substantial business presence test because it enhances the quality and availability of housing for zone residents, particularly disadvantaged persons. There

are no unusual circumstances suggesting that her potential tax benefit is not commensurate with her contribution.

Example 5. G Co., an international manufacturer, establishes a wholly-owned subsidiary, H Co., to run an assembly plant in a zone. H Co. employs 400 people, more than half of whom are zone residents. Certain designs and patterns used primarily by H Co. in its enterprise zone business appreciate significantly while H Co. operates in the zone. H Co. satisfies the significant business presence test because its employment of a large number of zone residents contributes to the revitalization of the zone. The presence of intangibles used exclusively in the zone business does not result in a potential tax benefit that is unusual in the context of a traditional assembly business. Therefore, H Co.'s potential tax benefit is commensurate with its contribution.

Example 6. J Co., a high-tech research organization establishes a wholly-owned subsidiary, K Co., in an enterprise zone. K Co. is exclusively engaged in the development of patentable concepts. K Co. employs four researchers and analysts who are not zone residents and three clerical workers who are zone residents. K Co. develops concepts and designs that appreciate greatly while K Co. operates in the zone. K Co. sells these concepts and designs to customers outside the zone. K Co. does not encourage local entrepreneurship or improve the delivery

of services to zone residents. Although K Co. does employ zone residents, this minimal increase in employment is disproportionate to the very large potential tax benefits that would result on the sale of the appreciated concepts and designs. K Co. does not satisfy the significant business presence test because its potential tax benefit is not commensurate with its contribution.

Example 7. L, which is owned by a zone resident, is a fast food franchise. L employs zone residents and serves zone customers. The franchise appreciates in value while L operates in the zone. L satisfies the significant business presence test because it represents local entrepreneurship, increases zone employment, and increases the availability and delivery of products to zone residents. Although its franchise might appreciate substantially, the franchise is used exclusively in the enterprise zone business. Its potential tax benefit is not unusual for an operating fast food franchise. Therefore, its potential tax benefit is commensurate with its contribution.

c. Termination of enterprise zone business status

Enterprise zone business status terminates on the first day a trade or business fails to satisfy all requirements for treatment as an enterprise zone business. A business whose status has terminated may not subsequently be treated as an enterprise zone business without the consent of the Secretary.

Regulations prescribed by the Secretary will provide that an enterprise zone business shall be given a reasonable period to correct an inadvertent termination of its status as an enterprise zone business. It is expected that the Secretary will prescribe adjustments appropriate to prevent a business or its investors from taking claiming tax incentives that relate to a period of disqualification.

d. Wage credit

Enterprise zone employees are eligible for a credit equal to 5% of the qualified wages not in excess of \$10,500. The credit is phased out between \$20,000 and \$25,000 of wages, whether or not such wages are qualified wages. An enterprise zone employee is an individual who performs services for an enterprise zone business that are directly related to the conduct of the business in the zone and are performed within the zone. Wages earned in connection with such employment are qualified wages. It is expected that the Secretary will provide regulations relating to activities by employees that are sufficiently connected with the zone business and the zone to constitute enterprise zone employment. The wage credit may be used against the employee's regular income tax and the alternative minimum tax, if any.

e. Capital gain exclusion - entity level

Capital gain recognized by an enterprise zone business on the disposition of enterprise zone property (other than in a

transaction with a related party) is excluded from gross income (in computing both regular and alternative minimum tax) to the extent it is attributable to the period during which the asset was used in an enterprise zone business. In the case of enterprise zone businesses that are partnerships or S corporations, the partner or shareholder is allocated his distributive share of the excluded gain, and his basis in the partnership interest or stock is increased by the amount of his distributive share of the excluded gain.

Enterprise zone property is any asset of an enterprise zone business (other than financial property and collectibles) that has been used in, and directly related to, the enterprise zone business for not less than a two-year period (a five-year period in the case of real property) immediately preceding the disposition of the property. In determining the holding period for an asset, any period during which the area in which the business is located has not been designated an enterprise zone is not taken into account. If enterprise zone business status has terminated, any gain subsequently recognized with respect to the business (whether by the business or by an investor in the business) is eligible for capital gain exclusion treatment only to the extent the taxpayer establishes that the amount of gain is the amount that would have been so treated if the asset or interest had been disposed of immediately before the termination for its fair market value immediately before the termination.

If the enterprise zone business sells enterprise zone property at a loss prior to the recognition of gain on other enterprise zone property, the subsequent gain is not excluded to the extent of the previously recognized loss. This rationalizes the results in cases where gain and loss assets are sold simultaneously with those where they are sold serially.

It is expected that the Secretary will prescribe regulations to ensure that tax benefits are not duplicated or improperly directed by means of combining or separating assets or by the use of related persons, pass-thru entities and other intermediaries. Examples are provided below in the general discussion of regulatory authority.

f. Capital gain exclusion - investor level

Capital gain on disposition of an ownership interest in an enterprise zone business (other than in a transaction with a related party) is generally excluded from the gross income of the interest holder (in computing both regular and alternative minimum tax) to the extent that the gain is attributable to enterprise zone property. This rule applies regardless of the form of the enterprise zone business. Generally, the portion of capital gain allocable to enterprise zone property is based on the percentage of income that would be excludable if the enterprise zone business had sold all of its assets for their

fair market value on the date of the disposition. The Secretary shall prescribe such regulations as are necessary to determine the amount of capital gain eligible for exclusion with respect to enterprise zone businesses with different classes of ownership interests or special allocations of gain or loss.

Investors apply gain and loss netting rules and rules for determining gain where enterprise zone business status has terminated that are similar to those applicable to the entity-level capital gain exclusion.

g. Ordinary loss treatment

Loss on disposition of enterprise zone business property is generally treated as ordinary loss for purposes of computing both regular and alternative minimum tax. Loss on disposition of an ownership interest in an enterprise zone business held for at least two years is generally treated as ordinary loss to the extent that such loss is allocable to enterprise zone property. Allocation rules similar to the rules provided for determining the excludable portion of capital gain on disposition of an interest in an enterprise zone business apply in determining the portion of a capital loss receiving ordinary loss treatment.

Gain and loss netting rules apply that are similar to those applicable to gain excluded from gross income.

h. Exclusion of gain from sale of a principal residence

A taxpayer may exclude capital gain recognized on the disposition of a residence located in an enterprise zone if the residence has been the taxpayer's principal residence for the 5-year period immediately preceding the disposition. The gain excluded by an individual and his spouse is subject to a \$200,000 lifetime limitation. Excluded gain must be attributable to the period during which an enterprise zone designation is in effect for the area.

i. Qualified small issue bonds

State and local governments may use the proceeds of tax-exempt bonds to make loans to an enterprise zone business for the acquisition of tangible property used in connection with the active trade or business of the enterprise zone business in the enterprise zone. Proceeds loaned to any enterprise zone business, aggregated with loans to any related parties, may not exceed \$250,000. Tax-exempt bonds used for this purpose are authorized as exempt-facility bonds and are subject to annual volume caps. This authority shall expire December 31, 1995.

j. Regulations

In addition to the specific regulatory authority described, the Secretary has all necessary and appropriate authority to prescribe regulations to effect the purposes of the Act. The following examples illustrate transactions that achieve tax

benefits that are not commensurate with the value provided to the enterprise zone or otherwise produce tax consequences inconsistent with the Act. The examples are only illustrative. It is expected that the Secretary will prescribe regulations to prevent abuses of the types described in the examples, to the extent that such transactions are not adequately prohibited by the statute.

Example 1: Inclusion of non-qualified assets. X owns 100 percent of the stock of a lumber yard located in an enterprise zone. X also owns a paved lot adjacent to the yard. X believes that the zone designation will result in substantial appreciation of real property in the zone. X contributes the lot to the lumber yard. A small portion of the lot is used for parking employees' autos and yard vehicles. The lot is also occasionally used to unload and temporarily store materials. Because the lot is used only occasionally and is not integral to the business, the lot is not used in, and directly related to, the active conduct of the lumber yard business. If the lot's value is substantial, the corporation will not qualify as an enterprise zone business. If the lot's value is low enough to permit the corporation to qualify as an enterprise zone business, the lot will nevertheless not qualify as enterprise zone property.

Example 2: Pass-thru Entities. A has a \$50 basis in XYZ partnership, an enterprise zone business. A's pro rata share of

XYZ's enterprise zone property has appreciated to \$100 since A acquired its interest. A sells its interest to B for \$100 and excludes \$50 of enterprise zone capital gain. Subsequently, XYZ sells its enterprise zone property. If no section 754 election has been made, B's pro rata share of XYZ's gain is \$50. If B's gain were treated as enterprise zone capital gain and B's basis were increased to reflect the gain, then B would have excludable gain and an offsetting built-in-loss in its partnership interest. Such a result would circumvent the purposes of the Act because it would allow tax benefits to B that are unrelated B's contribution to the enterprise zone. To avoid this result, regulations may provide one or more of the following: a section 754 election is required of all enterprise zone businesses that are partnerships; B's gain is not excluded because it is not attributable to enterprise zone property for the period that B held its interest; or B's basis is not increased for the portion of excluded gain attributable to the period prior to B's ownership. Regulations may also provide that if A and B acted in concert to produce the double benefit, exclusion to A and non-economic tax loss to B, that both the exclusion and the loss would be disallowed. Similar regulations may be prescribed for S corporations.

Example 3: Related Persons. Corporation A and Corporation B are members of a consolidated group. A purchases a commodity in a forward transaction for delivery January 1, 1995. A uses the commodity in its business. B sells the same commodity in a

forward transaction for delivery March 1, 1995. The price of the commodity increases, resulting in a gain to A and a loss to B. If A were an enterprise zone business and the gain were capital, A might have enterprise zone gain excluded from income while B had a capital loss. Regulations may deny treatment of the gain as enterprise zone capital gain because B, a related party, entered into an offsetting transaction.

Example 4: Related Persons. Corporation A and corporation B are members of a consolidated group. A licenses a formula from B that A uses in its enterprise zone business. Several years later, A assigns the license to C, an unrelated party, for \$1 million. Regulations may provide that A may treat the gain arising from the assignment of the license as enterprise zone business gain only if it establishes by substantial evidence that A's license was obtained from B for fair value.

Example 5: Appropriate allocation of intangibles. X Corporation operates a series of retail stores throughout State A. Each retail store is operated as a separate corporate subsidiary. Zone Sub is X Corporation's subsidiary operating in an enterprise zone. In addition to operating a retail store, Zone Sub also employs most of X Corporation's management, which is located in the zone. X Corporation sells the stock of a number of its subsidiaries, including Zone Sub to a single purchaser. The purchase price substantially exceeds the combined tangible asset

values of the subsidiaries. X Corporation allocates most of that excess to Zone Sub, the locus of management, and claims that the amount of the excess so allocated is goodwill that is excludable from income as enterprise zone capital gain. In addition to the challenges under general principles of tax law relating to the allocation of purchase price, locating management in an enterprise zone in an effort to attribute goodwill to the zone produces tax benefits that are not commensurate with the contribution to the zone. Regulations may provide that such goodwill must be allocated among X Corporation's subsidiaries. Regulations may also provide that X Corporation's management functions should be treated as a separate business from the retail outlet because they provide management services to all subsidiaries.

Example 6: Characterization of active trade or business. F, a non-zone resident, owns a deteriorated warehouse in the zone that is worth \$300,000 immediately prior to zone designation. F persuades X, an enterprise zone business, to lease space in the warehouse on an intermittent basis for the storage of delivery vans. F has no employees in the zone other than a security guard, who is a zone resident. The value of the warehouse rises to \$500,000 as a result of zone designation. Although F's warehouse is used by an enterprise zone business and F employs a zone resident, F's intermittent leasing of the warehouse does not constitute the active conduct of a rental business.

k. Effective date

These provisions are effective on enactment [January 1, 1993].

l. Revenue effect

These provisions are estimated to reduce fiscal year budget receipts by \$[]million, \$[]million, \$[]million, \$[]million and \$[] million in 1992, 1993, 1994, 1995, 1996 and 1997, respectively.

DRAFT -- 5/27/92

102d CONGRESS
2d SESSION

H.R. ____

To amend the Internal Revenue Code of 1986 to stimulate employment in, and to promote revitalization of, economically distressed areas designated as enterprise zones, by providing federal tax relief for employment and investment.

IN THE HOUSE OF REPRESENTATIVES

_____, 1992

A BILL

To amend the Internal Revenue Code of 1986 to stimulate employment in, and to promote revitalization of, economically distressed areas designated as enterprise zones, by providing federal tax relief for employment and investment.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

PART I -- OVERVIEW

SEC. 101. SHORT TITLE.

This Act may be cited as the "Enterprise Zone--Jobs Creation Act of 1992".

SEC. 102. PURPOSE.

It is the purpose of this Act to provide for the designation of economically distressed urban and rural areas as enterprise zones in order to stimulate the creation of new jobs in the enterprise zones, particularly for disadvantaged workers and long-term unemployed individuals, to enhance the availability and

delivery of local goods and services to residents and businesses in the enterprise zones, and to promote revitalization of the enterprise zones through meaningful entrepreneurial activity primarily by providing or encouraging --

- (1) tax relief at the Federal, State, and local levels;
- (2) regulatory relief at the Federal, State, and local levels; and
- (3) improved availability and delivery of local services and an increase in the economic stake of enterprise zone residents in their own community and its development, particularly through the increased involvement of private, local, and neighborhood organizations.

SEC. 103. EFFECTIVE DATE.

The amendments made by this Act shall apply to calendar years ending after December 31, [1992].

PART II -- DESIGNATION OF ENTERPRISE ZONES

SEC. 201. DESIGNATION OF ZONES.

(a) GENERAL RULE. -- Chapter 80 of subtitle F (relating to general rules) is amended by adding at the end thereof the following new subchapter:

"Subchapter D -- Designation of Enterprise Zones

"Sec. 7880 Designation

"SEC. 7880 DESIGNATION.

"(a) DESIGNATION OF ZONES.

"(1) DEFINITION. -- For purposes of this title, the term 'enterprise zone' means any area --

"(A) Which is nominated by one or more local governments and the State or States in which it is located for designation as an enterprise zone (hereinafter in this section referred to as a 'nominated area'), and

"(B) Which the Secretary of Housing and Urban Development, after consultation with --

"(i) The Secretaries of Agriculture, Commerce, Labor, and the Treasury; the Director of the Office of Management and Budget; and the Administrator of the Small Business Administration, and

"(ii) In the case of an area on an Indian reservation, the Secretary of the Interior, "designates as an enterprise zone.

"(2) AUTHORITY TO DESIGNATE. -- The Secretary of Housing and Urban Development is authorized to designate enterprise zones in accordance with the provisions of this section.

"(3) LIMITATIONS ON DESIGNATIONS. --

"(A) PUBLICATION OF REGULATIONS. -- Before designating any area as an enterprise zone, but not later than 4 months following the date of the enactment of this section, and after consultation with the officials described in paragraph (1)(B), the Secretary of Housing and Urban Development shall prescribe regulations setting

forth --

"(i) The procedures for nominating an area,
and

"(ii) The procedures for designation of an
area as an enterprise zone.

"(B) TIME LIMITATIONS. -- The Secretary of Housing and
Urban Development shall designate nominated areas as
enterprise zones only during the []-month period
beginning on the later of --

"(i) The first day of the first month
following the month in which the effective date of
the regulations described in subparagraph (A)
occurs, or

"(ii) [].

"(C) PROCEDURAL RULES. -- The Secretary of Housing and
Urban Development shall not make any designations under
this section unless --

"(i) The State and local governments in which
the nominated area is located have the authority
to--

"(I) nominate the area for designation as
an enterprise zone,

"(II) make the State and local
commitments under subsection (d), and

"[(III) provide reasonable assurances to
the Secretary of Housing and Urban Development

that such commitments will be fulfilled,] and

"(ii) a nomination therefor is submitted by the State and local governments in such a manner and in such form, and containing such information, as the Secretary of Housing and Urban Development shall prescribe by regulation.

"(b) TIME PERIOD FOR WHICH DESIGNATION IS IN EFFECT. --

"(1) IN GENERAL. -- Any designation of an area as an enterprise zone shall remain in effect during the period beginning on the date of the designation and ending on the earliest of --

"(A) December 31 of the 24th calendar year following the calendar year in which such date occurs,

"(B) the termination date specified by the State and local governments as provided in the nomination submitted in accordance with subsection (a)(3)(C)(ii),

"[(C) such other date as the Secretary of Housing and Urban Development shall specify as a condition of designation, or

"(D) the date upon which the Secretary of Housing and Urban Development revokes such designation].

"[(2) REVOCATION OF DESIGNATION. -- The Secretary of Housing and Urban Development, after consultation with the officials described in subsection (a)(1)(B), may revoke the designation of an area if the Secretary of Housing and Urban Development determines that a State or local government in which the area

is located is not complying substantially with the agreed course of action for the area.]

"(C) AREA AND ELIGIBILITY REQUIREMENTS

"(1) IN GENERAL. -- The Secretary of Housing and Urban Development may designate a nominated area as an enterprise zone if it meets the requirements of paragraphs (2) and (3).

"(2) AREA REQUIREMENTS. -- A nominated area meets the requirements of this paragraph if the area --

"(A) Is within the jurisdiction of the local government;

"(B) Has a continuous boundary; and

"(C) Either --

"(i) Has a population, as determined by the most recent census data available, of not less than --

"(I) [], if any portion of such area is located within a metropolitan statistical area (as designated by the Director of the Office of Management and Budget) with a population of [] or more; or

"(II) [] in any other case; or

"(ii) Is entirely within an Indian reservation (as determined by the Secretary of the Interior).

"(3) ELIGIBILITY REQUIREMENTS. -- A nominated area meets the requirements of this paragraph if the State and local governments in which the nominated area is located certify,

and the Secretary of Housing and Urban Development accepts such certification, that --

"(A) The area is one of pervasive poverty, unemployment and general distress;

"(B) The area is located wholly within the jurisdiction of a local government that is eligible for Federal assistance under section 119 of the Housing and Community Development Act of 1974, as in effect on the date of the enactment of this Act; and

"(C) The area satisfies the following requirements -

-

"(i) An unemployment rate for the area of at least [];

"(ii) A poverty rate (as determined by the most recent census data available) for each populous census tract (or where not tracted, the equivalent county division as defined by the Bureau of the Census for the purpose of defining poverty areas) within the area of at least []; and

"(iii) With respect to the area, either --

"(I) The percentage of below-median income households in the area within the jurisdiction of the local government (determined in the same manner as under section 119(b)(2) of the Housing and Community Development Act of 1974) is at least []; or

"(II) The rate of population decrease between 1980 and 1990 (or the most recent decade for which census data are available) is at least [].

"(4) ELIGIBILITY REQUIREMENTS FOR RURAL AREAS.-- For purposes of paragraph (1), a nominated area that is a rural area meets the requirements of paragraph (3) if the State and local governments in which it is located certify and the Secretary of Housing and Urban Development, after such review of supporting data as he deems appropriate, accepts such certification, that the area meets --

"(A) The criteria set forth in subparagraphs (A) and (B) of paragraph (3); and

"(B) Not less than one of the criteria set forth in the subparagraph (C) of paragraph (3).

"(B) not less than one of the criteria set forth in the subparagraph (C) of paragraph (3).

"(d) REQUIRED STATE AND LOCAL COMMITMENTS

"(1) IN GENERAL. -- No nominated area shall be designated as an enterprise zone unless the State and local governments of the jurisdictions in which the nominated area is located agree in writing that, during any period during which the nominated area is an enterprise zone, such governments will follow a specified course of action designed to reduce the various burdens borne by employers or employees in such area.

"(2) COURSE OF ACTION. -- The course of action under

paragraph (1) may include, but is not limited to --

"(A) the reduction or elimination of tax rates or fees applying within the enterprise zone,

"(B) actions to reduce, remove, simplify, or streamline governmental requirements applying within the enterprise zone,

"(C) an increase in the level or efficiency of local services within the enterprise zone, for example, crime prevention, and drug use prevention and treatment,

"(D) involvement in the program by private entities, organizations, neighborhood associations, and community groups, particularly those within the enterprise zone, including a commitment from such private entities to provide jobs and job training for, and technical, financial or other assistance to, employers, employees, and residents of the enterprise zone,

"(E) mechanisms to increase equity ownership by residents and employees within the enterprise zone,

"(F) donation (or sale below market value) of land and buildings to benefit low and moderate income people,

"(G) linkages to --

"(i) job training,

"(ii) transportation,

"(iii) education,

"(iv) day care,

"(v) health care, and

"(vi) other social service support,

"(H) provision of supporting public facilities, and infrastructure improvements,

"(I) encouragement of local entrepreneurship, and

"(J) other factors determined essential to support enterprise zone activities and encourage livability or quality of life.

"(3) LATER MODIFICATION OF A COURSE OF ACTION. -- The Secretary of Housing and Urban Development may by regulation prescribe procedures to permit or require a course of action to be updated or modified during the time that a designation is in effect.

"(e) DEFINITIONS. -- For the purposes of this title --

"(1) GOVERNMENTS. -- If more than one government seeks to nominate an area as an enterprise zone, any reference to, or requirement of, this section shall apply to all such governments.

"(2) STATE. -- The term 'State' shall also include the Puerto Rico, the Virgin Islands, Guam, American Samoa, the Northern Mariana Island, and any other territory of the United States.

"(3) LOCAL GOVERNMENTS. -- The term 'local government' means

--

"(A) Any country, city, town, township, parish, village, or other general purpose political subdivision of a State,

"(B) Any combination of political subdivisions described in subparagraph (A) recognized by the Secretary of Housing and Urban Development, and

"(C) The District of Columbia.

"(4) INDIAN RESERVATIONS. -- In the case of an Indian reservation, the reservation governing body (as determined by the Secretary of the Interior) shall be deemed to be both the State and local governments with respect to such area.

"(5) RURAL AREA. -- []

"(e) CROSS REFERENCES. --

"(1) Definitions, see section 1391,

"(2) Treatment of employees in enterprise zones, see section 1392, and

"(3) Treatment of investments in enterprise zones, see sections 1393 and 1394.

"(4) Exclusion of gain from disposition of principal residence located in enterprise zone, see section 1395."

(b) CONFORMING AMENDMENTS.

(1) The table of subchapters for chapter 80 of subtitle F is amended by adding at the end thereof the following new item:

"Subchapter D -- Designation of Enterprise Zones".

(2) The table of subchapters and sections for subtitle F is amended by adding after the item relating to subchapter C the following new item at the end of Chapter 80:

"Section D. Designation of Enterprise Zones

"Sec. 7880 Designation".

SEC. 202. REPORTING REQUIREMENTS

Not later than the close of the second calendar year after the calendar year in which the Secretary of Housing and Urban Development first designates areas as enterprise zones, and at the close of each second calendar year thereafter, the Secretary of Housing and Urban Development shall submit to the Congress a report on the effects of such designation in accomplishing the purposes of this subtitle.

SEC. 203. INTERACTION WITH OTHER FEDERAL PROGRAMS

(a) COORDINATION WITH RELOCATION ASSISTANCE. -- The designation of an enterprise zone under section 7880 shall not --

(1) constitute approval of a Federal or federally assisted program or project (within the meaning of the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970 (42 U.S.C. 4601)); or

(2) entitle any person displaced from real property located in such zone to any rights or any benefits under such Act.

(b) COORDINATION WITH ENVIRONMENTAL POLICY.

Designation of an enterprise zone under section 7880 shall not constitute a Federal action for purposes of applying the procedural requirements of the National Environmental Policy Act of 1969 (42 U.S.C. 4341) or other provisions of Federal law relating to the

protection of the environment.

PART III -- FEDERAL INCOME TAX INCENTIVES

SEC. 301. DEFINITIONS AND REGULATIONS; EMPLOYEE CREDIT; CAPITAL GAIN EXCLUSION.

(a) **GENERAL RULE.** -- Chapter 1 of subtitle A (relating to normal tax and surtax rules) is amended by adding the following new subchapter after subchapter T and before subchapter V:

"Subchapter U -- Enterprise Zones

"Sec. 1391 Definitions and regulatory authority.

"Sec. 1392 Credit for enterprise zone employees.

"Sec. 1393 Enterprise zone investor gain and loss.

"Sec. 1394 Enterprise zone business gain and loss.

"Sec. 1395 Enterprise zone gain from sale of principal residence.

"SEC. 1391 DEFINITIONS AND REGULATORY AUTHORITY.

"(a) **ENTERPRISE ZONE.** --

"(1) **IN GENERAL.** -- For purposes of this subchapter, the term 'enterprise zone' means any area which the Secretary of Housing and Urban Development designates pursuant to section 7880(a) as a Federal enterprise zone for purposes of this title.

"(2) **TERMINATION OF ENTERPRISE ZONE.** -- An area will cease to constitute an enterprise zone once its designation as such terminates [or is revoked] under section 7880(b).

"(b) **ENTERPRISE ZONE BUSINESS.** --

"(1) 'IN GENERAL. -- For purposes of this subchapter, the term 'enterprise zone business' means an actively conducted trade or business that the taxpayer establishes to the satisfaction of the Secretary as having a significant business presence in an enterprise zone. A trade or business has a significant business presence only if --

"(A) At least 80 percent of its gross income (without taking the exclusions under this subchapter into account) in each calendar year is derived from the active conduct of the trade or business within an enterprise zone,

"(B) Substantially all of its financial property and intangible assets are --

"(i) Used in, and directly related to, the active conduct of the trade or business within an enterprise zone, or

"(ii) Held for use by a transferee in, and directly related to the transferee's conduct of, the transferee's enterprise zone business,

"(C) Substantially all of its tangible property (whether owned or leased) is --

"(i) Located within an enterprise zone, and

"(ii) Used in, and directly related to, the active conduct of a trade or business in an enterprise zone,

however, no more than an insubstantial portion of the

tangible property may constitute collectibles (as defined in section 408(m)(2)) unless the collectibles constitute property held primarily for sale to customers in the ordinary course of the trade or business, and

"(D) With respect to its employees --

"(i) At least one-third are residents of an enterprise zone, and

"(ii) Substantially all services are performed within an enterprise zone, and compensation paid directly relates to work performed within an enterprise zone.

"In order to constitute an enterprise zone business, the trade or business must be the sole activity conducted by the proprietorship, partnership, or corporation conducting the trade or business. Once a trade or business ceases to constitute an enterprise zone business for any reason, it shall not subsequently be treated as an enterprise zone business without the consent of the Secretary.

"(2) RENTAL REAL PROPERTY. -- For purposes of this subsection (b), real property held for use by customers shall be treated as the active conduct of a trade or business.

"(3) OPERATING RULES. -- A trade or business shall not be treated as having a significant business presence in an enterprise zone unless the potential Federal tax benefits resulting from treatment as an enterprise zone business are commensurate with the contribution of the trade or business to

achieving the purposes of the Enterprise Zone--Jobs Creation Act of 1992.

"(A) FACTORS TAKEN INTO ACCOUNT. -- In determining the contribution of the trade or business, the following are among the factors taken into account --

"(i) The extent to which the equity interests in the trade or business are owned by residents of an enterprise zone,

"(ii) The extent to which the trade or business derives its income from the provision of goods and services in an enterprise zone,

"(iii) The extent to which the trade or business employs disadvantaged workers and long-term unemployed individuals in an enterprise zone, and

"(iv) The extent to which the trade or business contributes to the revitalization of economic activity in an enterprise zone through meaningful entrepreneurial activity.

"(B) DISQUALIFIED TRADE OR BUSINESS. -- Trades or businesses that shall not be treated as making contributions commensurate with the potential associated Federal tax benefits include the following --

"(i) RENTAL REAL PROPERTY. -- The holding of real property located within an enterprise zone for use by customers, except to the extent that --

"(I) The use is directly related to the conduct of the customer's enterprise zone business, or

"(II) The real property is residential rental property that has been substantially improved by the enterprise zone business.

"(ii) INTANGIBLE AND FINANCIAL PROPERTY. -- Any trade or business that includes the holding of intangible or financial property, except to the extent that the property is --

"(I) Used in, and directly related to, the active conduct of a trade or business in an enterprise zone (other than the trade or business of holding intangibles for use by transferees), or

"(II) Held for use by a transferee in, and directly related to the transferee's conduct of, the transferee's enterprise zone business.

"(iii) PERSONAL PROPERTY. -- The holding of personal property for use by customers, unless substantially all of the customers are enterprise zone businesses or residents of an enterprise zone.

["(iv) FINANCIAL TRADE OR BUSINESS. -- Any trade or business, more than 50 percent of the assets of which are financial property.]

["(v) GOVERNMENT-RELATED ACTIVITIES. -- Any trade or business conducted by, or principally for the benefit of, the Federal government, any State government or subdivision thereof, or any local government (as defined in section 7880(e)).]

"(c) RELATED PERSONS. -- For purposes of this subchapter, a person shall be treated as related to another person if --

"(1) the relationship of such persons is described in section 267(b) or 707(b)(1),

"(2) such persons are engaged in trades or businesses under common control (within the meaning of subsections (a) and (b) of section 52), or

"(3) such persons are acting pursuant to a plan or arrangement.

"For purposes of paragraph (1), section 267(b) and 707(b)(1) shall be applied by substituting '10 percent' for '50 percent.'

"(d) ENTERPRISE ZONE PROPERTY. -- For purposes of this section, the term 'enterprise zone property' means any asset (other than collectibles (as defined in section 408(m)) and financial property) that, for the period of at least 24 full calendar months (60 full calendar months in the case of real property) immediately preceding the determination as to the status of the asset, is used in, and directly related to, the active conduct of a trade or business while it is an enterprise zone business.

"(e) REGULATORY AUTHORITY. -- The rules of this subchapter must be applied in a manner that is consistent with and reasonably

carries out the purposes of the Enterprise Zone Jobs-Creation Act of [1992]. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out these purposes, including (but not limited to) regulations --

"(1) Providing that Federal tax benefits are available only to persons that contribute to the purposes of the Enterprise Zone Jobs-Creation Act of [1992],

"(2) Providing factors for determining the Federal tax benefits that are commensurate with the contribution to the purposes of the Enterprise Zone--Jobs Creation Act of 1992, including --

"(A) Factors for determining when --

"(i) Gross income is derived within an enterprise zone,

"(ii) Property or employees are located in an enterprise zone,

"(iii) Property is used in, and directly related to, an enterprise zone business, and

"(iv) Services are performed, and compensation relates to the performance of services performed, within an enterprise zone,

"(B) Special rules for instances when substantially all of the customers of a trade or business are residents of an enterprise zone, and

"(C) Limitations on the amount of Federal tax benefits to ensure that the benefits are commensurate

with the contribution.

"(3) Preventing circumvention of the purposes of the Enterprise Zone Jobs-Creation Act of [1992], including regulations to address --

"(A) Combining assets that contribute to the purposes with unrelated assets that do not contribute,

"(B) Separating, directly or indirectly, the ownership or disposition of interests in related assets that constitute enterprise zone property, and

"(C) Related persons, pass-thru entities, and other intermediaries or similar arrangements.

"(4) Providing for appropriate coordination with other Federal programs that, in combination, might enable activity within enterprise zones to be more than 100 percent subsidized by the Federal government,

"(5) Attributing gain or loss to property for the period that the property was directly related to, and used in, the enterprise zone business, and treating a trade or business as an enterprise zone business despite an inadvertent termination of that status, including transitional rules with respect to the commencement or termination of a trade or business or the designation of an area as an enterprise zone, and

"(6) Treating references to a trade or business or to a person as including a reference to a predecessor or successor.

"SEC. 1392 CREDIT FOR ENTERPRISE ZONE EMPLOYEES.

"(a) GENERAL RULE. -- In the case of a taxpayer who is an

enterprise zone employee, there shall be allowed as a credit against the tax imposed by this subtitle for the taxable year an amount equal to 5 percent of so much of the qualified wages of the taxpayer for the taxable year as does not exceed \$10,500.

"(b) DEFINITIONS. -- For purposes of this section --

"(1) ENTERPRISE ZONE EMPLOYEE. -- The term 'enterprise zone employee' means an individual if --

"(A) the individual renders services during the taxable year that are directly related to the conduct of an enterprise zone business (without regard to the requirement in section 1391(b)(2)(D)(ii) relating to a limitation on contributions),

"(B) substantially all the services described in paragraph (1)(A) directly relates to work performed within an enterprise zone, and

"(C) the employer for whom the services described in paragraph (1)(A) are performed is not the Federal government, any State government or subdivision thereof, or any local government.

"(2) WAGES. -- The term 'wages' has the meaning given by subsection (b) of section 3306 (determined without regard to any dollar limitation contained in such subsection).

"(3) QUALIFIED WAGES. -- The term 'qualified wages' means all wages of the taxpayer, to the extent attributable to services described in paragraph (1).

"(c) LIMITATIONS. --

"(1) 'PHASE-OUT OF CREDIT. -- The amount of the credit allowable to a taxpayer under subsection (a) for any taxable year shall not exceed the excess (if any) of --

"(A) \$525, over

"(B) 10.5 percent of so much of the taxpayer's total wages (whether or not constituting qualified wages) as exceeds [\$20,000].

"(2) PARTIAL TAXABLE YEAR. -- If designation of an area as an enterprise zone occurs, expires, [or is revoked] pursuant to section 7880 on a date other than the first or the last day of the taxable year of the taxpayer, or in the case of a short taxable year, the limitations specified in subsection (c)(1) shall be adjusted on a pro rata basis (based upon the number of days).

"(d) CREDIT TREATED AS SUBPART C CREDIT. -- For purposes of this title, the credit allowed under subsection (a) shall be treated as a credit allowed under subpart C of part IV of subchapter A of chapter 1 of subtitle A.

"(e) REGULATORY AUTHORITY. -- The Secretary shall provide regulations as necessary and appropriate to identify employee activities that are sufficiently connected with an enterprise zone business and an enterprise zone to qualify the employee as an enterprise zone employee.

"SEC. 1393 ENTERPRISE ZONE INVESTOR GAIN AND LOSS.

"(a) GENERAL RULE. -- Gross income does not include any amount of gain constituting enterprise zone investor gain. Any enterprise

zone investor loss is treated as ordinary loss.

"(b) ENTERPRISE ZONE INVESTOR GAIN OR LOSS. --

"(1) IN GENERAL. -- The term 'enterprise zone investor gain' means long-term capital gain, and the term 'enterprise zone investor loss' means any loss, recognized with respect to the disposition of stock or a partnership interest in an enterprise zone business held by the taxpayer for at least 24 full calendar months immediately preceding the disposition, to the extent the taxpayer establishes that the amount is attributable to enterprise zone property for the period that the property was directly related to, and used in, the enterprise zone business. For this purpose, a 'disposition' means any event in which gain or loss is recognized, in whole or in part.

"(2) SPECIAL RULES. --

"(A) RELATED PARTY TRANSACTIONS. -- Gain or loss is not treated as enterprise zone investor gain or loss if attributable, directly or indirectly, in whole or in part, to a transaction with a related person.

"(B) TERMINATION OF ENTERPRISE ZONE BUSINESS. -- For purposes of this section, notwithstanding termination of the treatment of a trade or business as an enterprise zone business, the gain or loss recognized with respect to stock or a partnership interest following the termination shall be treated as enterprise zone investor gain or loss to the extent the taxpayer establishes that

the amount of gain or loss is the amount that would have been so treated if the interest had been disposed of immediately before the termination for its fair market value immediately before the termination. In no event may the cumulative amount treated as enterprise zone investor gain or loss exceed the net amount that would have been so treated if all of the taxpayer's interests in the enterprise zone business had been disposed of immediately before the termination for their fair market value immediately before the termination.

"(C) RECAPTURE OF GAIN OR LOSS. -- Gain (or loss) for any year shall not be treated as enterprise zone investor gain (or loss) to the extent such gain (or loss) does not exceed the cumulative excess (if any) of loss (or gain) previously recognized over gain (or loss) previously recognized with respect to the disposition of stock or a partnership interest in an enterprise zone business. For this purpose, except as otherwise provided in regulations, all related persons are treated as one person.

"(c) BASIS. -- Amounts excluded from gross income pursuant to subsection (a) shall not be applied in reduction to the basis of any property held by the taxpayer.

"(d) FRAUD OR WILLFUL NEGLECT. -- If the treatment of any gain or loss as enterprise zone investor gain or loss is due, in whole or in part, to the taxpayer's fraud or willful neglect, all such gain

shall be treated as ordinary income (and not as enterprise zone investor gain) and all such loss shall be treated as loss from the sale or exchange of a capital asset (and not as enterprise zone investor loss).

"SEC. 1394 ENTERPRISE ZONE BUSINESS GAIN AND LOSS.

"(a) GENERAL RULE. -- Gross income does not include any amount of gain constituting enterprise zone business gain. Any enterprise zone business loss is treated as ordinary loss.

"(b) ENTERPRISE ZONE BUSINESS GAIN OR LOSS. --

"(1) IN GENERAL. -- The term 'enterprise zone business gain' means long-term capital gain, and the term 'enterprise zone business loss' means any loss, recognized with respect to the disposition by an enterprise zone business of enterprise zone property, to the extent the enterprise zone business establishes that the amount is attributable to the period that the property was directly related to, and used in, the enterprise zone business. For this purpose, a 'disposition' means any event in which gain or loss is recognized, in whole or in part.

"(2) SPECIAL RULES. --

"(A) RELATED PARTY TRANSACTIONS. -- Gain or loss is not treated as enterprise zone business gain or loss if attributable, directly or indirectly, in whole or in part, to a transaction with a related person.

"(B) TERMINATION OF ENTERPRISE ZONE BUSINESS. -- For purposes of this section, notwithstanding termination of

the treatment of a trade or business as an enterprise zone business, the gain or loss recognized by the trade or business with respect to an asset following the termination shall be treated as enterprise zone business gain or loss to the extent the taxpayer establishes that the amount of gain or loss with respect to that asset is the amount that would have been so treated if all of the enterprise zone property had been disposed of immediately before the termination for its fair market value immediately before the termination. In no event may the cumulative amount treated as enterprise zone business gain or loss exceed the net amount that would have been so treated if all of the enterprise zone property had been disposed of immediately before the termination for its fair market value immediately before the termination.

"(C) RECAPTURE OF GAIN OR LOSS. -- Gain (or loss) for any year shall not be treated as enterprise zone business gain (or loss) to the extent such gain (or loss) does not exceed the cumulative excess (if any) of enterprise zone business loss (or gain) previously recognized over enterprise zone business gain (or loss) previously recognized with respect to enterprise zone property. For this purpose, except as otherwise provided in regulations, all related persons are treated as one person.

"(c) BASIS. -- Amounts excluded from gross income pursuant to

subsection (a) 'shall not be applied in reduction to the basis of any property held by the enterprise zone business.

"(d) FRAUD OR WILLFUL NEGLECT. -- If the treatment of any gain or loss as enterprise zone business gain or loss is due, in whole or in part, to the taxpayer's fraud or willful neglect, all such gain shall be treated as ordinary income (and not as enterprise zone business gain) and all such loss shall be treated as loss from the sale or exchange of a capital asset (and not as enterprise zone business loss).

"SEC. 1395 ENTERPRISE ZONE GAIN FROM SALE OF PRINCIPAL RESIDENCE.

"(a) GENERAL RULE. -- At the election of the taxpayer, gross income does not include any amount of gain constituting enterprise zone gain from a principal residence.

"(b) ENTERPRISE ZONE GAIN FROM A PRINCIPAL RESIDENCE. --

"(1) IN GENERAL. -- The term 'enterprise zone gain from a principal residence' means gain recognized by a taxpayer from the sale or exchange of real property that --

"(A) Is located in an enterprise zone, and

"(B) During the period of the designation as an enterprise zone, the property has been owned and used by the taxpayer as his principal residence for the 5-year period ending on the date of the sale or exchange.

"(2) DOLLAR LIMITATIONS. --

"(A) LIFETIME LIMITATION. -- Subsection (a) shall not apply to any sale or exchange by the taxpayer to the extent that such application, when combined with other

elections by the taxpayer and his spouse under subsection (a), exceed \$200,000 (\$100,000 in the case of a separate return by a married individual).

"(B) ATTRIBUTION TO PERIOD FOLLOWING ZONE DESIGNATION. -- Gain shall be treated as enterprise zone gain from a principal residence only to the extent that the taxpayer establishes that it is attributable to the period that the area in which the property is located is designated as an enterprise zone.

"(c) ELECTION. -- An election under subsection (a) may be made or revoked at any time before the expiration of the period for making a claim for credit or refund of the tax imposed by this chapter for the taxable year in which the sale or exchange occurred, and shall be made or revoked in such manner as the Secretary shall by regulations prescribe. In the case of a taxpayer who is married, an election under subsection (a) or revocation thereof may be made only if his spouse joins in such election or revocation.

"(d) SPECIAL RULES. -- For purposes of this section --

"(1) PROPERTY HELD JOINTLY BY HUSBAND AND WIFE. -- If property is held by a husband and wife as joint tenants, tenants by the entirety, or community property, only one spouse must satisfy the requirements of subsection (b)(1).

"(2) TENANT-STOCKHOLDER IN COOPERATIVE HOUSING CORPORATION. -- If the taxpayer holds stock as a tenant stockholder (as defined in section 216) in a cooperative housing corporation (as

defined in such section), then --

"(A) The ownership requirements of subsection (b) (1) shall be applied to the holding of the stock, and

"(B) The remaining requirements of subsection (b) shall be applied to the unit which the taxpayer was entitled to occupy as the stockholder.

"(3) INVOLUNTARY CONVERSIONS. -- The destruction, theft, seizure, requisition, or condemnation of property shall be treated as the sale of the property.

"(4) PROPERTY USED IN PART AS PRINCIPAL RESIDENCE. -- If the ownership and use requirements of subsection (b) are satisfied with respect to only a portion of property, this section shall only apply with respect to so much of the gain from the sale or exchange of the property as is attributable to the portion of the property so owned and used.

"(5) DETERMINATION OF MARITAL STATUS. -- The determination of whether an individual is married shall be made as of the date of the sale or exchange, and an individual legally separated from his spouse under a decree of divorce or separate maintenance is not considered as married.

"(6) APPLICATION OF SECTIONS 121, 1033, AND 1034. -- This section shall apply before the application of sections 121 (relating to one-time exclusion of gain from sale or exchange of residence), 1033 (relating to involuntary conversions), and 1034 (relating to rollover of gain from sale or exchange of residence). For purposes of applying those sections, the

amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to this section, reduced by the amount of gain not included in gross income pursuant to this section.

"(7) PROPERTY ACQUIRED AFTER INVOLUNTARY CONVERSION. -- If the basis of the property sold or exchanged is determined, in whole or in part, under subsection (b) of section 1033 (relating to basis of property acquired through involuntary conversion) then the ownership and use by the taxpayer of the converted property shall be treated as ownership and use by the taxpayer of the property sold or exchanged.

"(8) BASIS. -- Amounts excluded from gross income pursuant to subsection (a) shall not be applied in reduction to the basis of any property held by the taxpayer.".

(b) CLERICAL AMENDMENTS. --

(1) The table of subchapters and sections for subtitle A is amended by adding the following new subchapter after subchapter T and before subchapter V of chapter 1:

"Subchapter U -- Enterprise Zones

"Sec. 1391 Definitions and regulatory authority

"Sec. 1392 Credit for enterprise zone employees

"Sec. 1393 Enterprise zone investor gain and loss

"Sec. 1394 Enterprise zone business gain and loss

"Sec. 1395 Enterprise zone gain from sale of principal residence".

(2) The table of subchapters for chapter 1 is amended by

adding the following new subchapter after subchapter T and before subchapter V:

"Subchapter U -- Enterprise zones."

(3) Section 121 (relating to one-time exclusion from gross income of gain from sale of a principal residence) is amended by adding the following cross reference at the end thereof:

"(e) CROSS REFERENCE. -- For exclusion from gross income of gain from sale of a principal residence located in an enterprise zone, see section 1395."

(4) Section 1034(1) (relating to cross reference for purposes of rollover of gain from sale of principal residence) is amended to read as follows:

"(1) CROSS REFERENCE. -- For other rules excluding from gross income gain with respect to sale of principal residence --

"(1) See section 121, with respect to a one-time election for individuals who have attained age 55, and

"(2) See section 1395, with respect to principal residences located in enterprise zones."

SEC. 302. QUALIFIED ENTERPRISE ZONE BONDS.

(a) GENERAL RULE. -- Parts IV and IX of Subchapter B (relating to computation of taxable income) of Chapter 1 of subtitle A (relating to normal tax and surtax rules) are amended as follows:

(1) AMENDMENT OF SECTION 142(A). -- Section 142(a) (relating to exempt facility bonds) is amended by adding the following

new paragraph at the end thereof:

"(12) Qualified enterprise zone facilities."

(2) ADDITION OF NEW SECTION 142(J). -- Section 142 is amended by adding the following new subsection at the end thereof:

"(j) QUALIFIED ENTERPRISE ZONE FACILITIES. --

"(1) IN GENERAL. -- For purposes of subsection (a)(12), except as otherwise provided in this paragraph (1), the term 'qualified enterprise zone facilities' means tangible property (within the meaning of section 1391(b)(1)(C)) located within an enterprise zone (as defined in section 1391(a)(1)) that is or will be used with respect to an enterprise zone business within the meaning of section 1391(b). Facilities used for the provision of housing (rental or otherwise) are not qualified enterprise zone facilities. Facilities that are qualified enterprise zone facilities are deemed to be used for a public use.

"(2) LIMITATION ON AMOUNT OF BONDS. -- This subsection (j) shall not apply if, at any time, the aggregate amount of any outstanding bonds used or to be used with respect to any single enterprise zone business exceeds \$250,000. For purposes of this \$250,000 limitation, with respect to an issue that refunds another issue the proceeds of which were used to finance qualified enterprise zone facilities, only that portion of the refunding issue that exceeds the portion of the issue being refunded is taken into account.

"(3) REASONABLE EXPECTATION REQUIREMENT. -- This subsection

(j) shall not apply to any issue unless, as of the date of issue of the bonds, the persons or entities operating the trade or business reasonably expect the business to qualify as an enterprise zone business at all times during the 5-year period immediately succeeding the later of the date of issue of the bonds or the date of commencement of business operations. In the event the business ceases to qualify as an enterprise zone business within the 5-year period, any expectation of compliance for the requisite 5-year period is presumed not to be reasonable unless it is shown to the satisfaction of the Secretary that noncompliance occurred for bona fide reasons unrelated to tax-exemption of the bonds."

(d) ADDITION OF NEW SECTION 147(H) (3). -- Section 147(h) is amended by adding the following new paragraph at the end thereof:

"(3) BONDS FOR QUALIFIED ENTERPRISE ZONE FACILITIES. -- Subsections (c) and (d) shall not apply to any bonds the proceeds of which are used to finance qualified enterprise zone facilities."

(e) AMENDMENT TO SECTION 265(B) (3) (B) (II) (I). -- Section 265(b) (3) (B) (ii) (I) is amended to read as follows:

"(I) Any qualified 501(c)(3) bond (as defined in section 145) and any bonds elected not to be treated as private activity under subsection (b) (3) (B) (iii) of this section, or".

(f) Addition of new section 265(b) (3) (B) (iii). -- Section

265(b)(3)(B) is amended by adding the following new clause at the end thereof:

"(iii) Election no to treat qualified enterprise zone facility bonds as private activity bonds. -- An issue the proceeds of which are used to finance qualified enterprise zone facilities (as defined in section 142(j)) is not treated as a private activity bond if, on or prior to the date of issue of the bonds, the issuer irrevocably elects not to treat the bonds as private activity bonds for purposes of subsection (b)(3)(B)(ii)(I) of this section."

SEC. 303. ALTERNATIVE MINIMUM TAX.

(a) Section 56(g)(4)(B) (relating to adjustments based on adjusted current earnings of corporations) is amended by adding the following new clause at the end thereof:

"(iii) EXCLUSION OF ENTERPRISE ZONE CAPITAL GAIN.-- Clause (i) shall not apply to any amount treated as enterprise zone investor gain (as defined in section 1393) or enterprise zone business gain (as defined in section 1394), and such gain shall not be included in income for purposes of computing alternative minimum taxable income.".

(b)

PART IV -- REGULATORY FLEXIBILITY**SEC. 401. DEFINITION OF SMALL ENTITIES IN ENTERPRISE ZONE FOR PURPOSES OF ANALYSIS OF REGULATORY FUNCTIONS. --**

Section 601 of title 5, United States Code, is amended by --

(1) striking out "and" at the end of paragraph (5); and

(2) striking out paragraph (6) and inserting in lieu thereof the following:

"(6) the term 'small entity' means --

"(A) a small business, small organization, or small governmental jurisdiction defined in paragraphs (3), (4), and (5) of this section, respectively; and

"(B) any qualified enterprise zone business; any unit of government that nominated an area which the Secretary of Housing and Urban Development designates as an enterprise zone (within the meaning of section 7880 of the Internal Revenue Code of 1986) that has a rule pertaining to the carrying out of any project, activity, or undertaking within such zone; and any not-for-profit enterprise carrying out a significant portion of its activities within such a zone; and

"(7) the term 'qualified enterprise zone business' means any person, corporation, or other entity --

"(A) which is engaged in the active conduct of a trade or business within an enterprise zone (within the meaning of section 7880 of the Internal Revenue Code of 1986); and

"(B) at least 50 percent of the employees of which are qualified employees (within the meaning of section 1392(b)(1) of such Code).".

SEC. 402. WAIVER OR MODIFICATION OF AGENCY RULES IN ENTERPRISE ZONES.

(a) Chapter 6 of title 5, United States Code, is amended by redesignating sections 611 and 612 as section 612 and 613, respectively, and inserting the following new section immediately after section 610:

"SEC. 611 Waiver or modification of agency rules in enterprise zones.

"(a) Upon the written request of any government which nominated an area that the Secretary of Housing and Urban Development has designated as an enterprise zone under section 7880 of the Internal Revenue Code of 1986, an agency is authorized, in order to further the job creation, community development, or economic revitalization objectives with respect to such zone, to waive or modify all or part of any rule which it has authority to promulgate, as such rule pertains to the carrying out of projects, activities, or undertakings within such zone.

"(b) Nothing in this section shall authorize an agency to waive or modify any rule adopted to carry out a statute or Executive order which prohibits, or the purpose of which is to protect persons against, discrimination on the basis of race, color, religion, sex, familial status, national origin, age, or

handicap.

"(c) A request under subsection (a) shall specify the rule or rules to be waived or modified and the change proposed, and shall briefly describe why the change would promote the achievement of the job creation, community development, or economic revitalization objectives of the enterprise zone. If such a request is made to any agency other than the Department of Housing and Urban Development, the requesting government shall send a copy of the request to the Secretary of Housing and Urban Development at the time the request is made.

"(d) In considering a request, the agency shall weigh the extent to which the proposed change is likely to further job creation, community development, or economic revitalization within the enterprise zone against the effect the change is likely to have on the underlying purposes of applicable statutes in the geographic area which would be affected by the change. The agency shall approve the request whenever it finds, in its discretion, that the public interest which the proposed change would serve in furthering such job creation, community development, or economic revitalization outweighs the public interest which continuation of the rule unchanged would serve. The agency shall not approve any request to waive or modify a rule if that waiver or modification would --

"(1) violate a statutory requirement (including any requirement of the Fair Labor Standards Act of 1938 (52 Stat. 1060; 29 U.S.C. 201 et seq.)); or

"(2) 'be likely to present a significant risk to the public health, including environmental or occupational health or safety, or of environmental pollution.

"(e) If a request is disapproved, the agency shall inform all the requesting governments, and the Department of Housing and Urban Development, in writing of the reasons therefor and shall, to the maximum extent possible, work with such governments to develop an alternative, consistent with the standards contained in subsection (d).

"(f) Agencies shall discharge their responsibilities under this section in an expeditious manner, and shall make a determination on requests not later than 90 days after their receipt.

"(g) A waiver or modification of a rule under subsection (a) shall not be considered to be a rule, rulemaking, or regulation under chapter 5 of this title. To facilitate reaching its decision on any requested waiver or modification, the agency may seek the views of interested parties and, if the views are to be sought, determine how they should be obtained and to what extent, if any, they should be taken into account in considering the request. The agency shall publish a notice in the Federal Register stating any waiver or modification of a rule under this section, the time such waiver or modification takes effect and its duration, and the scope of applicability of such waiver or modification.

"(h) In the event that an agency proposes to amend a rule for which a waiver or modification under this section is in effect, the

agency shall not change the waiver or modification to impose additional requirements unless it determines, consistent with standards contained in subsection (d), that such action is necessary. Such determinations shall be published with the proposal to amend such rule.

"(i) No waiver or modification of a rule under this section shall remain in effect with respect to an enterprise zone after the enterprise zone designation has expired [or has been revoked].

"(j) For purposes of this section, the term 'rule' means (1) any rule as defined in section 551(4) of this title or (2) any rulemaking conducted on the record after opportunity for an agency hearing pursuant to sections 556 and 557 of this title.".

(b) The table of sections for such chapter is amended by redesignating sections 611 and 612 as section 612 and 613, respectively, and inserting the following immediately before section 612, as redesignated by subsection (a):

"Sec. 611 Waiver or modification of agency rules in enterprise zones.".

(c) Section 601(2) of such title is amended by inserting "(except for purposes of section 611)" immediately before "means".

(d) Section 613 of such title, as redesignated by subsection (a), is amended --

(1) in subsection (a) by inserting "(except section 611)" immediately after "chapter"; and

(2) in subsection (b) by inserting "as defined in section 601(2)" immediately before the period at the end of the first

sentence.

SEC. 403. FEDERAL AGENCY SUPPORT OF ENTERPRISE ZONES.

In order to maximize all agencies' support of enterprise zones, the Secretary of Housing and Urban Development is authorized to convene regional and local coordinating councils of any appropriate agencies to assist State and local governments to achieve the objectives agreed to in the course of action under section 7880 of the Internal Revenue Code of 1986.

**PART V -- ESTABLISHMENT OF FOREIGN-TRADE ZONES
IN ENTERPRISE ZONES**

SEC. 501. FOREIGN-TRADE ZONE PREFERENCES.

(a) PREFERENCE IN ESTABLISHMENT OF FOREIGN-TRADE ZONES IN REVITALIZATION AREAS. -- In processing applications for the establishment of foreign-trade zones pursuant to an Act "To provide for the establishment, operation, and maintenance of foreign-trade zones in ports of entry of the United States, to expedite and encourage foreign commerce, and for other purposes", approved June 18, 1934 (48 Stat. 998), the Foreign-Trade Zone Board shall consider on a priority basis and expedite, to the maximum extent possible, the processing of any application involving the establishment of a foreign trade zone within an enterprise zone designated pursuant to section 7880 of the Internal Revenue Code of 1986.

(b) APPLICATION PROCEDURE. -- In processing applications for the establishment of ports of entry pursuant to "An Act making

appropriations for sundry civil expenses of the Government for the fiscal year ending June thirtieth, nineteen hundred and fifteen, and for other purposes", approved August 1, 1914 (38 Stat. 609), the Secretary of the Treasury shall consider on a priority basis and expedite, to the maximum extent possible, the processing of any application involving the establishment of a port of entry which is necessary to permit the establishment of a foreign-trade zone within an enterprise zone so designated.

(c) APPLICATION EVALUATION. -- In evaluating applications for the establishment of foreign-trade zones and ports of entry in connection with enterprise zones so designated, the Foreign-Trade Zone Board and the Secretary of the Treasury shall approve the applications, to the maximum extent practicable, consistent with their respective statutory responsibilities.

**PART VI -- REPEAL OF TITLE VII OF THE HOUSING AND COMMUNITY
DEVELOPMENT ACT OF 1987**

SEC. 601. REPEAL.

Title VII of the Housing and Community Development Act of 1987 is hereby repealed.