

September 2003

**TAX
ADMINISTRATION**

**Information Is Not
Available to
Determine Whether
\$5 Billion in Liberty
Zone Tax Benefits
Will Be Realized**



TAX ADMINISTRATION



Highlights

Highlights of [GAO-03-1102](#), a report to the Honorable Charles B. Rangel, Ranking Minority Member, Committee on Ways and Means, House of Representatives, and the Honorable Carolyn B. Maloney, House of Representatives

Why GAO Did This Study

The President pledged a minimum of \$20 billion in assistance to New York for response and recovery efforts after the September 11, 2001, terrorist attacks. This includes tax benefits, commonly referred to as the Liberty Zone tax benefits, that the Joint Committee on Taxation (JCT) estimated would reduce federal tax revenues by about \$5 billion. The actual amount of benefits realized, however, will depend on the extent to which taxpayers and the city and state of New York take advantage of them.

GAO was asked to determine

- the extent to which the Internal Revenue Service (IRS) is collecting and reporting information about the number of taxpayers using each of the seven Liberty Zone tax benefits and the revenue loss associated with those benefits and
- if IRS is not collecting and reporting this information, what steps it would need to take and what resources would be needed to do so.

GAO is making no recommendations in this report. The Commissioner of Internal Revenue was provided a draft of this report for his review and comment. The IRS Director of Tax Administration Coordination agreed with the contents of the report.

www.gao.gov/cgi-bin/getrpt?GAO-03-1102.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

Information Is Not Available to Determine Whether \$5 Billion in Liberty Zone Tax Benefits Will Be Realized

What GAO Found

For one of the seven Liberty Zone tax benefits, the business employee credit, IRS is collecting but not planning to report some information about use—the number of taxpayers claiming the credit and the amount of credit claimed—nor is it planning to use this information to report the revenue loss associated with that benefit. IRS is not planning to collect or report information about the use of the other six benefits or the revenue loss associated with those benefits. According to IRS officials, the agency followed its usual procedures in determining whether to collect information about benefit use and revenue loss. IRS officials said they would collect and report these data if (1) it would help the agency administer the tax laws or (2) IRS was legislatively mandated to do so.

IRS would need to make several changes if it were to collect more information on the use of the benefits and the associated revenue loss, and this information would not be complete or lead to a verifiable measure of the reduction in federal tax revenues due to the benefits. IRS would need to change forms, processing procedures, and computer programming, which would add to taxpayer burden and IRS's workload. IRS officials were unable to estimate the costs involved in accomplishing these actions or the number of staff needed to do so. The officials said that the earliest they could make these changes would be for tax year 2004 returns. As a result, IRS would not have information for two of the years that the benefits were in effect, which is significant because most of the benefits expire by the end of 2006. In addition, if IRS were to collect data on the use of the Liberty Zone benefits, it would be able to make an estimate, but could not produce a verifiable measure, of the revenue loss due to the benefits because, for example, IRS would have to make assumptions about how taxpayers would have behaved in the absence of the benefits.

New York Liberty Zone



Source: GAO.

Contents

Letter		1
	Results in Brief	2
	Background	3
	IRS Generally Not Planning to Collect or Report Information about the Use of Liberty Zone Tax Benefits or Reductions in Taxpayers' Tax Liabilities	4
	Several Changes Needed If IRS Were to Collect and Report More Information about the Liberty Zone Tax Benefits and Estimate Revenue Losses	6
	Agency Comments	9
Appendix I	Objectives, Scope, and Methodology	11
Appendix II	Summary of the Liberty Zone Tax Benefits	12
Table		
	Table 1: Example of Recalculation of Taxable Income	8

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.



G A O

Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

September 30, 2003

The Honorable Charles B. Rangel
Ranking Minority Member
Committee on Ways and Means
House of Representatives

The Honorable Carolyn B. Maloney
House of Representatives

The President pledged a minimum of \$20 billion in assistance to New York for response and recovery efforts after the terrorist attacks of September 11, 2001. The \$20 billion includes about \$15 billion of congressionally appropriated funds, primarily administered by the Department of Housing and Urban Development, Department of Transportation, and Federal Emergency Management Agency (FEMA), for different types of assistance.¹ The remaining assistance came in the form of tax benefits, which the Joint Committee on Taxation (JCT) estimated would reduce federal revenues by about \$5 billion. These tax benefits are commonly referred to as the Liberty Zone tax benefits.² Because of your interest in whether the \$5 billion in tax benefits will be realized, you asked us to determine the extent to which the Internal Revenue Service (IRS) is collecting and reporting information about the number of taxpayers using each of the seven Liberty Zone tax benefits and the revenue loss associated with those benefits. In addition, if IRS is not collecting and reporting this information, you asked us to determine what steps it would need to take and what resources would be needed to do so.

To address these objectives, we interviewed IRS and city and state of New York officials and analyzed information they provided, as well as JCT data, about the use and revenue effects of the Liberty Zone tax benefits. We also discussed the steps IRS would need to take to collect information on the

¹ In March 2003, FEMA became a part of the Department of Homeland Security. Also, a small portion of the funds are administered by other agencies such as the Small Business Administration and the Department of Labor. We will report additional information about the total benefits provided to New York later this year.

² The New York Liberty Zone is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the city of New York.

use and revenue effects of the benefits and the resources it would need to do so. For the purposes of this report, we defined use as the number of taxpayers who claimed each benefit and the amount each claimed. However, the amount that taxpayers claim on their returns is not the same as the reduction in tax liabilities due to using the benefits. Because some of the Liberty Zone tax benefits substitute for less generous deductions or credits to which taxpayers would otherwise be entitled, the net reduction in taxpayers' tax liabilities (and net reduction in federal revenues) can only be determined by comparing taxpayers' tax liabilities with the benefits in place to their tax liabilities when only the alternate deductions and credits are available.³ Our scope and methodology are discussed in greater detail in appendix I.

Results in Brief

For one of the seven Liberty Zone tax benefits, the business employee credit, IRS is collecting but not planning to report some information about use—the number of taxpayers claiming the credit and the amount of credit claimed—nor is it planning to use this information to report on the revenue loss associated with that benefit. IRS is not planning to collect or report information about the use of the other six benefits or the revenue loss associated with those benefits. IRS can collect information on the use of the business employee credit because it developed a new form to administer this credit. However, IRS currently cannot collect information on the remaining six Liberty Zone benefits because it is using existing forms to administer them, and taxpayers do not report these six benefits as separate items on their returns. According to IRS officials, the agency followed its usual procedures in determining whether to collect information about benefit use and revenue loss. IRS officials said they would collect and report these data if (1) it would help the agency administer the tax laws or (2) IRS was legislatively mandated to do so.

IRS would need to make several changes if it were to collect more information on the use of the benefits and the associated revenue loss, and this information would not be complete or lead to a verifiable measure of the reduction in federal tax revenues due to the benefits. IRS would need to change forms, processing procedures, and computer programming,

³ JCT's \$5 billion estimate of the reduction in federal tax revenues is not exactly the same as the economic value of the benefits to taxpayers. For example, the JCT estimate, which covers a 10-year time frame, does not completely reflect the fact that taxpayers who claim the expensing deduction today would receive smaller deductions in the future than they otherwise could have claimed.

which would add to taxpayer burden and IRS's workload. For example, changing the form that taxpayers use to claim depreciation so that they report separately the amount of depreciation due to the special Liberty Zone depreciation allowance would result in increased taxpayer burden. IRS's workload would also increase because, among other things, it would be processing additional information on depreciation. IRS officials were unable to estimate the costs involved in accomplishing these actions or the number of staff needed to do so. They said that the earliest they could make these changes would be for tax year 2004 returns. As a result, IRS would not have information for two of the years that the benefits were in effect, which is significant because most of the benefits expire by the end of 2006. In addition, if IRS were to collect data on the use of the Liberty Zone benefits, it would be able to make an estimate, but could not produce a verifiable measure, of the revenue loss due to the benefits because, for example, IRS would have to make assumptions about how taxpayers would have behaved in the absence of the benefits.

The Commissioner of Internal Revenue was provided a draft of this report for his review and comment. The IRS Director of Tax Administration Coordination agreed with the contents of the report.

Background

To assist New York in recovering from the September 11, 2001, terrorist attacks, Congress passed Public Law 107-147, the Job Creation and Worker Assistance Act of 2002. The act was signed into law on March 9, 2002, and created seven tax benefits that focus on the New York Liberty Zone. The Liberty Zone tax benefits include

- treating employees in the Liberty Zone as a targeted group for purposes of the work opportunity tax credit (WOTC), which IRS refers to as the business employee credit;
- a special depreciation allowance;
- an increase in section 179 expensing;
- special treatment of leasehold improvement property;
- an extension of the replacement period for involuntarily converted property;
- authority to issue tax-exempt private activity bonds; and
- authority to issue advance refunding bonds.

An explanation of each benefit, an example of how it can be used, and the period each benefit is in effect are included in appendix II.

Under the Congressional Budget Act of 1974 as amended, JCT provides estimates of the revenue consequences of tax legislation. In March 2002, JCT estimated that the New York Liberty Zone tax benefits would reduce federal revenues by \$5.029 billion over the period 2002 through 2012.⁴

IRS Generally Not Planning to Collect or Report Information about the Use of Liberty Zone Tax Benefits or Reductions in Taxpayers' Tax Liabilities

For one of the seven Liberty Zone tax benefits, the business employee credit, IRS is collecting but not planning to report some information about use—the number of taxpayers claiming the credit and the amount of credit claimed—nor is it planning to use this information to report on how the benefit has reduced taxpayers' tax liabilities. IRS is not planning to collect or report information about the use of the other six benefits or how using these benefits has reduced taxpayers' tax liabilities.

IRS collects information on how many taxpayers use the business employee credit and the amount of the credit claimed on Form 8884 (New York Liberty Zone Business Employee Credit). Submission processing officials in the Small Business/Self-Employed (SB/SE) Division began entering information from this form into IRS's computer system in January 2003. Some taxpayers claiming the business employee credit may have their returns processed by the Wage and Investment (W&I) Division, which is not planning to enter information from the form into the computer system. However, IRS officials said that the bulk of the taxpayers who would claim this credit would submit their returns to the SB/SE Division.

IRS can collect information on the use of the business employee credit because it developed a new form to administer this credit. Although the business employee credit was included in the WOTC provisions, IRS officials said they needed to track business employee credits separately because the business employee credit can be used to offset any alternative minimum taxes owed but the general WOTC provisions cannot.⁵ IRS currently cannot collect information on the remaining six Liberty Zone benefits because it is using existing forms to administer them, and

⁴ Joint Committee on Taxation, *Estimated Revenue Effects of the "Job Creation and Worker Assistance Act of 2002" Fiscal Years 2002-2012* (Washington, D.C.: Mar. 6, 2002), 2.

⁵ The alternative minimum tax is a separate tax computation required of some taxpayers whose taxable incomes exceed certain thresholds and who otherwise would owe little or no taxes because they are claiming certain special deductions and credits.

taxpayers do not report these six benefits as separate items on their returns. For example, taxpayers add the amount of depreciation they are allowed under the Liberty Zone special depreciation allowance benefit to other depreciation expenses and report their total depreciation expenses on their returns. Since taxpayers do not report their use of six of the seven benefits separately on their returns, IRS cannot report on how extensively these six benefits were used.

IRS officials said that although they are collecting information on the amount of business employee credits claimed by taxpayers, they are not planning on reporting information on the extent to which the benefit reduced taxpayers' tax liabilities. For the other six benefits, IRS officials said that without information about use, they cannot collect or report on the extent to which the benefits reduced taxpayers' tax liabilities.⁶

According to IRS officials, the agency followed its usual procedures in determining the type of information to collect about the Liberty Zone tax benefits. They added that IRS would collect and report information that would help it to administer the tax laws or if it was legislatively mandated to collect or report information. IRS officials said they do not need information about the use of the Liberty Zone tax benefits or the resulting reductions in taxpayers' tax liabilities in order to administer the tax laws. For example, IRS officials said that they do not need information on each specific benefit claimed to properly target their enforcement efforts. Instead, they target their enforcement efforts based on taxpayers claiming various credits, deductions, and so forth that fall outside of expected amounts. In addition, IRS officials noted that the agency has not been legislatively mandated to collect or report information on the benefits.

⁶ Bond issuers also receive economic benefits from tax-exempt bonds because they pay less interest than they would have had to pay on the same amount of bonds that were not tax exempt. IRS could use forms prepared by bond issuers to collect information about the two Liberty Zone bond benefits, such as the maturity date and issue prices. Information on the bonds issued is also available from the city and state of New York.

Several Changes Needed If IRS Were to Collect and Report More Information about the Liberty Zone Tax Benefits and Estimate Revenue Losses

IRS would need to make several changes if it were to collect more information on taxpayers' use of the benefits and their effect on reducing taxpayers' tax liabilities. IRS would need to change forms used to collect information from taxpayers, change how it processes information from tax returns, and revise computer programming, which would add to taxpayer burden and IRS's workload. Even if it were to make these changes, IRS would not have information for two of the years the benefits were available. Also, although the additional information would enable IRS to make an estimate of the revenue loss due to the benefits, it would not be able to produce a verifiable measure of the loss. To produce the estimate, IRS would have to make assumptions about how taxpayers would have behaved in the absence of the benefits.

Several Changes Needed If IRS Were to Report on Use of Benefits and Reduction in Taxpayers' Tax Liabilities

For six of seven of the Liberty Zone tax benefits, IRS would need to revise forms, tax return processing procedures, and computer programming if it were to collect and report information about the number of taxpayers claiming the benefit and the amount they claimed. It would also need to take most of these steps to report on the use of the seventh benefit—the business employee credit. According to IRS officials, they would need to make staff available to revise forms, review returns for completeness and accuracy, transcribe the additional data, and write the necessary computer programs for entering and extracting data. They would also need to allocate computer resources to process the additional information collected and prepare reports on the use of the benefits. For example, for the special depreciation allowance benefit, IRS would need to revise

- Form 4562 (Depreciation and Amortization) so that taxpayers reported the amount of depreciation they claimed specifically due to this benefit,
- tax return processing procedures so that processing staff reviewed Form 4562 for completeness and accuracy and transcribed information about the special depreciation allowance, and
- computer programming so that information about the special depreciation allowance could be entered into IRS's information systems and extracted in order to prepare reports about the use of the benefit.

For the seventh benefit—the business employee credit—taxpayers already separately report the amount of the credit they are claiming, and IRS is already reviewing these forms for accuracy and completeness, transcribing data from them, and entering this information into the agency's computer system for those returns that are processed by the SB/SE Division. However, computer programming would need to be changed to extract information to prepare reports about benefit use. For

any returns processed by the W&I Division, IRS would also need to revise W&I processing procedures and computer programming.

Since IRS currently does not have any plans to make these changes, officials were unable to estimate the costs involved in accomplishing these actions or the number of staff needed to do so. However, IRS officials estimated they added one full-time equivalent (FTE) primarily to review the Form 8884s for completeness and accuracy and for data transcription—part of the process to collect information about the use of the business employee credit.⁷

If IRS collected information about the use of the benefits, IRS could then develop some information on the reduction in taxpayers' tax liabilities due to the benefits. For example, IRS could determine how much lower each taxpayer's tax liability is due to the use of the tax benefits, assuming that taxpayer behavior would be the same whether the benefits existed or not. Table 1 is an example of such a computation for claiming the Liberty Zone Section 179 expensing benefit. In this example, a taxpayer with \$100,000 in income bought \$40,000 worth of office equipment in 2002 and placed this equipment in service in the Liberty Zone in 2002. After applying the Liberty Zone section 179 expensing benefit, taxable income would be \$60,000. Since the equipment has been completely expensed, the taxpayer cannot claim any further deductions for this equipment. To recalculate the taxpayer's taxable income as if the special Liberty Zone expensing benefit did not exist, IRS could assume that the taxpayer would make the same investment, even without the Liberty Zone tax benefit, and still claim the \$24,000 section 179 deduction available to all taxpayers in 2002 and any other available deductions, such as the special depreciation allowance. In our example, the special depreciation allowance would be worth \$4,800, and the amount otherwise available as a depreciation deduction (regular depreciation) would be worth \$1,600, which would reduce the taxpayer's taxable income to \$69,600. The total reduction in taxable income would be \$9,600.

⁷ An FTE consists of one or more employees who collectively work for 1 year. For example, one full-time employee or two half-time employees equal one FTE.

Table 1: Example of Recalculation of Taxable Income

Taxpayer calculation of taxable income with Liberty Zone expensing benefit		Recalculation of taxable income with standard deductions	
Income	\$100,000	Income	\$100,000
Less:		Less:	
Liberty Zone Section 179	(40,000)	Standard Section 179	(24,000)
		Special depreciation	(4,800)
		Regular depreciation	(1,600)
Taxable income	\$60,000	Taxable income	\$69,600

Sources: IRS and GAO.

Note: GAO analysis of IRS information.

Once all the adjustments to taxable income were made, IRS would then need to apply the appropriate marginal tax rate to arrive at the taxpayer's recalculated tax liability.

IRS Could Produce Estimates but Not a Verifiable Measure of the Revenue Loss

If IRS were to begin collecting information on the number of taxpayers using the Liberty Zone tax benefits and the amounts they claimed, the information would not be complete. In addition, although the information would enable IRS to make an estimate of the revenue loss due to the benefits, the information would not result in a verifiable measure of the loss. To produce the estimate, IRS would have to make assumptions about how taxpayers would have behaved in the absence of the benefits.

IRS said the earliest it would be able to collect information on the number of taxpayers using the benefits and the amounts each claimed would be for tax year 2004 returns, which IRS would not process until calendar year 2005. As a result, IRS would not have information for two of the years that the benefits were in effect, which is significant because most of the benefits expire by the end of 2006.⁸ IRS could not reconstruct information on tax liability for those 2 years because returns already filed would not indicate whether taxpayers used the Liberty Zone benefits and would not show the amount claimed through benefit use. Although IRS could ask for information about past benefit use since taxpayers are instructed to keep tax records for 3 years, this would require taxpayers to provide additional information and increase taxpayer burden. Also, it would be difficult for

⁸ Details on the expiration dates for each benefit are given in app. II.

IRS to use current year information to estimate the amount claimed through benefit use retroactively because the pattern of using the benefits could have changed over time.

In addition to not being complete, the data that IRS could collect on the number of taxpayers using the Liberty Zone benefits and the amounts each claimed would not be sufficient for actually measuring how much revenue those benefits cost the federal government. The reduction in revenues due to the Liberty Zone tax benefits is equal to the difference between the amount of revenue that the federal government would collect with the benefits in place and the amount it would collect in the absence of those benefits. There are two reasons why revenues would be different with and without the benefits. First, the rules for computing tax liabilities are different in the two cases (as shown in table 1). Second, the behavior of many taxpayers is likely to be different in the two cases. In fact, a primary purpose of the tax benefits is to influence taxpayer behavior. For example, in the case of the Liberty Zone section 179 benefit, some taxpayers who claim this benefit would have made different investment decisions if that particular benefit were not available. In our simplified example shown in table 1, this difference in behavior might be that the taxpayer invested less than \$40,000 in office equipment—perhaps even nothing—because the Liberty Zone benefit did not exist. As a consequence, the taxpayer's taxable income would have been different than the \$69,600 shown in table 1. Given that IRS cannot know what taxpayers would have done in the absence of the benefits, the best it could do is estimate revenue losses based on assumptions about that alternative behavior.

Agency Comments

The Commissioner of Internal Revenue was provided a draft of this report for his review and comment. The IRS Director of Tax Administration Coordination agreed with the contents of the report.

As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from its date. At that time, we will send copies to the Chairman and Ranking Minority Member of the Senate Committee on Finance; the Chairman of the House Committee on Ways and Means and the Chairman and Ranking Minority Member of its Subcommittee on Oversight; the Secretary of the Treasury; the Commissioner of Internal Revenue; the Director of the Office of Management and Budget; and other interested parties. We will make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

This report was prepared under the direction of Jonda Van Pelt, Assistant Director. If you have any questions regarding this report, please contact her at (415) 904-2186 or vanpeltj@gao.gov or me at (202) 512-9110 or brostekm@gao.gov. Key contributors to this report were Evan Gilman, Edward Nannenhorn, Lynne Schoenauer, Shellee Soliday, Anne Stevens, and James Wozny.



Michael Brostek
Director, Tax Issues

Appendix I: Objectives, Scope, and Methodology

Our first objective was to determine the extent to which the Internal Revenue Service (IRS) is collecting and reporting information about the use and value of the seven Liberty Zone tax benefits. We defined use as the number of taxpayers who claimed each benefit and the amount each claimed. In analyzing value, we examined what information IRS could provide about reductions in taxpayers' tax liabilities when they used the Liberty Zone tax benefits, and then examined whether this information could be used to measure the actual reduction in federal tax revenues. To address the first objective, we interviewed IRS officials from Legal Counsel, the Wage and Investment (W&I) Division's and the Small Business/Self-Employed (SB/SE) Division's submission processing groups, Statistics of Income (SOI), Forms and Publications, and the Tax Exempt Government Entities (TEGE) Division to determine if they were collecting and reporting any information about the use of the Liberty Zone tax benefits and how the benefits reduced taxpayers' tax liabilities. We analyzed the documents they provided about collecting and reporting on the use of the benefits and the reduction in taxpayers' tax liabilities. We also analyzed the data the Joint Committee on Taxation (JCT) provided about its estimate of the reduction in federal tax revenues. Finally, we interviewed New York city and state officials to determine if they were collecting and reporting information on the benefits.

Our second objective was to determine what steps IRS would need to take and the resources it would need to collect and report information on the use and value of the Liberty Zone tax benefits if it is not already doing so. We used the same definition of use and value as we used for the first objective. To address the second objective, we interviewed IRS officials from Legal Counsel, the W&I Division's and the SB/SE Division's submission processing groups, SOI, Forms and Publications, and the TEGE Division to determine what steps they would need to take and the resources they would need to collect and report information on the use of the Liberty Zone tax benefits and the reduction in taxpayers' tax liabilities if they used the benefits. We also analyzed IRS documents related to the steps that would need to be taken to collect and report on the use of the benefits and on the reduction in taxpayers' tax liabilities.

We performed our work from April 2003 through August 2003 in accordance with generally accepted government auditing standards.

Appendix II: Summary of the Liberty Zone Tax Benefits

Liberty Zone tax benefit ^a	Benefit summary	Example of the benefit	Effective dates
Business employee credit	<p>The work opportunity tax credit (WOTC) was expanded to include a new targeted group for employees who perform substantially all their services for a business in the Liberty Zone or for a business that relocated from the Liberty Zone elsewhere within New York City due to the physical destruction or damage of their workplaces by the September 11, 2001, terrorist attacks.</p> <p>The New York Liberty Zone business employee credit allows eligible businesses with an average of 200 or fewer employees to take a maximum credit of 40 percent of the first \$6,000 in wages paid or incurred for work performed by each qualified employee during calendar years 2002 and 2003. Unlike the other targeted groups under WOTC, the credit for the new group is available for wages paid to both new hires and existing employees.</p>	<p>An employee works at a small company located in the Liberty Zone from June 1, 2002, to October 31, 2002, and receives \$3,000 in wages a month. The company can claim a credit for 40 percent of the first \$6,000 in wages paid (\$2,400).</p>	<p>Wages paid or incurred for qualified employees during calendar years 2002 and 2003</p>
Special depreciation allowance	<p>The special depreciation allowance provides an additional deduction for eligible properties. Eligible Liberty Zone properties include new tangible property (e.g., new office equipment), used tangible property (e.g., used office equipment), and residential rental property (e.g., an apartment complex) and nonresidential real property (e.g., an office building) if it rehabilitates real property damaged or replaces real property destroyed or condemned as a result of the September 11, 2001, terrorist attacks.</p> <p>For property inside the Liberty Zone, the special depreciation allowance allows taxpayers to deduct 30 percent of the adjusted basis of qualified property acquired by purchase after September 10, 2001, and placed in service on or before December 31, 2006 (December 31, 2009, in the case of nonresidential real property and residential rental property). For property outside the Liberty Zone, a special depreciation allowance is available for taxpayers but only with regard to qualified property—such as new tangible property and non-Liberty Zone leasehold improvement property—that is acquired after September 10, 2001, and before September 11, 2004, and is placed in service on or before December 31, 2004. However, recent legislation (the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27) has increased the deduction to 50 percent for qualified property both within and outside the Liberty Zone that is acquired after May 5, 2003, and placed in service on or before December 31, 2004.</p>	<p>On December 1, 2002, a real estate development firm purchases an office building in the New York Liberty Zone that costs \$10 million and places it in service on June 1, 2003. The building replaces real property damaged as a result of the September 11, 2001, terrorist attacks. Under the provision, the taxpayer is allowed an additional first-year depreciation deduction of 30 percent (\$3 million).</p>	<p>Residential rental property and nonresidential real property: Acquired by purchase after September 10, 2001, and placed in service on or before December 31, 2009</p> <p>New and used tangible property: Acquired by purchase after September 10, 2001, and placed in service on or before December 31, 2006</p>

**Appendix II: Summary of the Liberty Zone
Tax Benefits**

Liberty Zone tax benefit^a	Benefit summary	Example of the benefit	Effective dates
Section 179 expensing	<p>Taxpayers with a sufficiently small investment in qualified section 179 business property in the Liberty Zone can elect to deduct rather than capitalize the amount of their investment and are eligible for an increased amount over other taxpayers. For qualified Liberty Zone property placed in service during 2001 and 2002, under section 179 taxpayers could deduct up to \$59,000 (\$24,000 under the general provision plus an additional \$35,000) of the cost. The investment limit (phase-out range) in the property was \$200,000. For qualified Liberty Zone property placed in service after 2002 and before 2007, taxpayers could deduct \$60,000 (\$25,000 under the general provision plus the additional \$35,000) of the cost.</p> <p>However, recent legislation (Pub. L. No. 108-27) has further increased the maximum deduction for qualified Liberty Zone property placed in service after 2002 and before 2006 to \$135,000 and has increased the investment limit to \$400,000. For 2006, the maximum section 179 deduction allowed for qualified Liberty Zone property returns to \$60,000 and the investment limit is \$200,000. To calculate the available expensing treatment deduction amount for qualified Liberty Zone property, every dollar for which 50 percent of the cost of the property exceeds the investment limit is subtracted from the maximum deduction allowed.</p> <p>Taxpayers outside of the Liberty Zone may also expense qualified property under section 179. However, the maximum deduction for non-Liberty Zone property is \$35,000 less than the maximum deduction allowed for Liberty Zone property. The investment limits for Liberty Zone and non-Liberty Zone property are similar. However, in contrast, in calculating the available expensing treatment deduction amount for non-Liberty Zone properties, every dollar invested in the property that exceeds the investment limit is subtracted from the maximum deduction allowed.</p>	<p>In 2002, a taxpayer purchases and places in service in his or her Liberty Zone business several qualified items of equipment costing a total of \$260,000. Because 50 percent of the cost of the property (\$130,000) is less than \$200,000, the investment limit, the section 179 deduction of \$59,000 is not reduced, and the taxpayer can deduct this amount.</p>	<p>Effective for section 179 property placed in service after September 10, 2001, and on or before December 31, 2006</p>

**Appendix II: Summary of the Liberty Zone
Tax Benefits**

Liberty Zone tax benefit^a	Benefit summary	Example of the benefit	Effective dates
Leasehold improvement property	<p>Qualified Liberty Zone leasehold improvement property can be depreciated over a 5-year period using the straight-line method of depreciation. The term “qualified Liberty Zone leasehold property” means property as defined in section 168(k)(3) and may include items such as additional walls and plumbing and electrical improvements made to an interior portion of a building that is nonresidential real property. Qualified Liberty Zone leasehold improvements must be placed in service in a nonresidential building that is located in the Liberty Zone after September 10, 2001, and on or before December 31, 2006. The class life for qualified New York Liberty Zone leasehold improvement property is 9 years for purposes of the alternative depreciation system.</p> <p>Taxpayers can also depreciate leasehold improvements outside of the Liberty Zone. These taxpayers can depreciate an addition or improvement to leased nonresidential real property using the straight-line method of depreciation over 39 years. Qualified leasehold improvement properties outside the Liberty Zone can qualify for both the 39-year depreciation deduction and the special depreciation allowance. However, leasehold improvements inside the Liberty Zone do not qualify for the special depreciation allowance.</p>	<p>In 2004, a taxpayer buys and places in service \$100,000 in additional walls for a leased office building in the Liberty Zone. For each tax year from 2004 through 2008, the taxpayer can deduct up to one-fifth of the cost of the property.</p>	<p>Effective for property placed in service after September 10, 2001, and on or before December 31, 2006</p>
Replacement period for involuntarily converted property	<p>A taxpayer may elect not to recognize gain with respect to property that is involuntarily converted if the taxpayer acquires qualified replacement property within an applicable period. The replacement period for property that was involuntarily converted in the Liberty Zone as a result of the September 11, 2001, terrorist attacks is 5 years after the end of the taxable year in which a gain is realized provided that substantially all of the use of the replacement property is in New York City. The involuntarily converted Liberty Zone property can be replaced with any tangible property held for productive use in a trade or business because taxpayers in presidentially declared disaster areas such as the Liberty Zone can use any tangible, productive use property to replace property that was involuntarily converted.</p> <p>Outside of the Liberty Zone, the replacement period for involuntarily converted property is 2 years (3 years if the converted property is real property held for the productive use in a trade or business or for investment), and the converted property must be replaced with replacement property that is similar in service or use.</p>	<p>A taxpayer held a truck for productive use in a Liberty Zone business, but it was destroyed in the September 11, 2001, terrorist attacks. Several years ago, the taxpayer paid \$50,000 for the truck and, over time, depreciated the basis in the truck to \$30,000. If the insurance company paid \$35,000 in reimbursement for the truck and the taxpayer used the \$35,000 to purchase replacement property of any type that is held for productive use in a trade or business within 5 years after the close of the tax year of payment by the insurance company, the taxpayer would not recognize a gain.</p>	<p>Effective for involuntary conversions in the Liberty Zone occurring on or after September 11, 2001, as a result of the terrorist attacks on that date</p>

**Appendix II: Summary of the Liberty Zone
Tax Benefits**

Liberty Zone tax benefit^a	Benefit summary	Example of the benefit	Effective dates
Private activity bonds	An aggregate of \$8 billion of tax-exempt private activity bonds, called qualified New York Liberty bonds, are authorized to finance the acquisition, construction, reconstruction, and renovation of certain property that is primarily located in the Liberty Zone. Qualified New York Liberty bonds must finance nonresidential real property, residential rental property, or public utility property and must also satisfy certain other requirements. The Mayor of New York City and the Governor of New York State may each designate up to \$4 billion in qualified New York Liberty bonds.	The Mayor of New York City designates \$120 million of qualified New York Liberty bonds to finance the construction of an office building in the Liberty Zone.	Effective for bonds issued after March 9, 2002 (the date of enactment of the Job Creation and Worker Assistance Act of 2002), and on or before December 31, 2004
Advance refunding bonds	An aggregate of \$9 billion of advance refunding bonds may be issued to pay principal, interest, or redemption price on certain prior issues of bonds issued for facilities located in New York City (and certain water facilities located outside of New York City). Under this benefit, certain qualified bonds, which were outstanding on September 11, 2001, and had exhausted existing advance refunding authority before September 12, 2001, are eligible for one additional advance refunding. The Mayor of New York City and the Governor of New York State may each designate up to \$4.5 billion in advance refunding bonds.	The Governor of New York State designates \$70 million of advance refunding bonds to refinance bonds that financed the construction of hospital facilities in New York City.	Effective for advance refunding bonds issued after March 9, 2002, and on or before December 31, 2004

Sources: Public Law 107-147, IRS, and GAO.

^aThe Liberty Zone tax benefits were enacted as part of the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147.

GAO's Mission

The General Accounting Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to e-mail alerts" under the "Order GAO Products" heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are \$2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
 TDD: (202) 512-2537
 Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm

E-mail: fraudnet@gao.gov

Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548