
Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits

A Report to the
Governor
and the
Legislature of
the State of
Hawai'i

Report No. 12-05
July 2012



THE AUDITOR
STATE OF HAWAI'I

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai'i State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. Financial audits attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.
2. Management audits, which are also referred to as performance audits, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called program audits, when they focus on whether programs are attaining the objectives and results expected of them, and operations audits, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
3. Sunset evaluations evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.
4. Sunrise analyses are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.
5. Health insurance analyses examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.
6. Analyses of proposed special funds and existing trust and revolving funds determine if proposals to establish these funds are existing funds meet legislative criteria.
7. Procurement compliance audits and other procurement-related monitoring assist the Legislature in overseeing government procurement practices.
8. Fiscal accountability reports analyze expenditures by the state Department of Education in various areas.
9. Special studies respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawai'i's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.



THE AUDITOR

STATE OF HAWAII

Kekuanao'a Building

465 S. King Street, Room 500

Honolulu, Hawai'i 96813

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai'i State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

1. Financial audits attest to the fairness of the financial statements of agencies. They examine the adequacy of the financial records and accounting and internal controls, and they determine the legality and propriety of expenditures.
2. Management audits, which are also referred to as performance audits, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called program audits, when they focus on whether programs are attaining the objectives and results expected of them, and operations audits, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
3. Sunset evaluations evaluate new professional and occupational licensing programs to determine whether the programs should be terminated, continued, or modified. These evaluations are conducted in accordance with criteria established by statute.
4. Sunrise analyses are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.
5. Health insurance analyses examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.
6. Analyses of proposed special funds and existing trust and revolving funds determine if proposals to establish these funds are existing funds meet legislative criteria.
7. Procurement compliance audits and other procurement-related monitoring assist the Legislature in overseeing government procurement practices.
8. Fiscal accountability reports analyze expenditures by the state Department of Education in various areas.
9. Special studies respond to requests from both houses of the Legislature. The studies usually address specific problems for which the Legislature is seeking solutions.

Hawai'i's laws provide the Auditor with broad powers to examine all books, records, files, papers, and documents and all financial affairs of every agency. The Auditor also has the authority to summon persons to produce records and to question persons under oath. However, the Office of the Auditor exercises no control function, and its authority is limited to reviewing, evaluating, and reporting on its findings and recommendations to the Legislature and the Governor.



THE AUDITOR

STATE OF HAWAII

Kekuanao'a Building

465 S. King Street, Room 500

Honolulu, Hawai'i 96813



Office of the Auditor
465 S. King Street
Rm. 500
Honolulu, HI 96813
Ph. (808) 587-0800

Marion M. Higa
State Auditor
State of Hawai'i

**“It’s all in [my]
head.”**

*—DoTAX returns
classifying officer’s
response when asked
why he does not have
any written policies
and procedures to
guide him through the
audit identification and
selection process.*

Recommendations

Response

Previous Audits

For the full text of this and other
reports, visit our website:
<http://www.state.hi.us/auditor>

Audit of the Department of Taxation’s Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits

Report No. 12-05, July 2012

DoTAX Struggled To Manage a Deficient High-Technology Tax Credit Law

Deficient tax credit law provided no guidance to department

High-technology business investment and research activities tax credits were created in Act 178, Session Laws of Hawai'i (SLH) 1999, as part of a broader effort by the State to stimulate the growth and development of high-technology industries in Hawai'i. Although Act 178 contained eight initiatives, the tax credits would later become the hallmark of this legislation.

Initially, the tax credit was equivalent to 10 percent of the investment in each qualified high technology business (QHTB), with a maximum of \$500,000 for the taxable year. In 2001, via Act 221, the tax credit was increased to 100 percent, claimable over five years with a maximum of \$2 million per investment per QHTB, quadrupling the allowable amount per investment. The law did not provide a maximum total cumulative amount of tax credits available to taxpayers, so the amount of tax expense to the State was unlimited. In addition, the research activities tax credit was a refundable credit and the amount was equal to 20 percent of all QHTB qualified research expenditures.

In our audit, we found that the tax credits law and its subsequent amendments, which sunset in 2010, did not contain any goals and performance measures to effectively measure the tax credits. We also found that other states administer similar tax credits outside their taxation departments and their reporting requirements mandate disclosure of taxpayer information by law. In addition, the numerous amendments to the law increased the number of tax credit claims and gave the Department of Taxation (DoTAX) more administrative responsibilities related to the tax credits. Finally, because the law was silent as to the expectations of DoTAX, it implemented the tax credits as it had for all tax credits by issuing forms and guidance, auditing taxpayer returns, and reporting on the credits in its existing reports. As a result, the State can neither measure nor ensure the effectiveness of the nearly \$1 billion in tax credits.

Taxpayers may receive tax credits for which they do not qualify

In 2004, the law was amended to require that DoTAX certify the amount of tax credits for all taxpayers claiming the credit by verifying the nature and amount of the qualifying investments. Given the high volume of applications and a short window of time in which to certify them, DoTAX performs only a high-level review that does not verify self-reported numbers; it basically just “checks the math” on the form. In addition, DoTAX audits only a fraction of all taxpayers claiming the tax credits. We utilized existing data from various reports and found that for tax years 2001–2004, an average of less than 3 percent of the total number of high-technology tax claims were audited.

Although the credits have sunset, there may be similar initiatives on the horizon that the Legislature may wish to support by way of state policy. At that time, the Legislature should consider imbedding a means to measure effectiveness, including specific goals, performance standards, and an evaluation process. Without well-understood expectations and the appropriate infrastructure in place to support the initiative, the State will never know the success of its policies.

Response of the Affected Agency

In its response, the department expressed its appreciation for our report. The department concurs with our finding that the continuous legislative changes since 1999 increased the complexity of the tax credit provision and the department’s responsibilities. To address our recommendations, the department is in the process of filling vacant and other positions needed to complete reporting on the tax credits for prior years. Lastly, the director assured us that the department will continue to review our recommendations for improvements.

Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits

A Report to the
Governor
and the
Legislature of
the State of
Hawai'i

Submitted by

THE AUDITOR
STATE OF HAWAI'I

Report No. 12-05
July 2012

Foreword

This is a report on the audit of the Department of Taxation's administrative oversight of high-technology business investment and research activities tax credits. The Auditor initiated this audit on the basis of a constitutional and statutory duty to conduct post-audits of the transactions, accounts, programs and performance of all departments, offices, and agencies of the State and its political subdivisions. These duties are provided for in Article VII, Section 10 of the State Constitution and Section 23-4, Hawai'i Revised Statutes.

We wish to express our appreciation for the cooperation and assistance extended to us by the director and staff of the Department of Taxation, and others whom we contacted during the course of the audit.

Marion M. Higa
State Auditor

Table of Contents

Chapter 1 Introduction

Background.....	1
Objectives of the Audit	8

Chapter 2 DoTAX Struggled To Manage a Deficient High-Technology Tax Credit Law

Summary of Findings	11
A Deficient High-Technology Tax Credit Law Provided No Guidance to DoTAX	11
DoTAX’s Processing, Monitoring, and Reporting of High-Technology Tax Credits Lack Transparency and Are Inadequate and Unreliable.....	28
Conclusion.....	40
Recommendations.....	41

Response of the Affected Agency.....	43
---	-----------

List of Exhibits

Exhibit 1.1	Department of Taxation Organization Chart	3
Exhibit 1.2	Cash Investment Received by 419 QHTBs, by Year	6
Exhibit 2.1	Comparison of Law Amendments With GFOA Best Practices	14
Exhibit 2.2	Comparison of Selected States’ Investment Tax Credits	15
Exhibit 2.3	Tables From Minnesota’s 2011 Report on Angel Tax Credit Program Revealing Taxpayer Information.....	16
Exhibit 2.4	Estimated Investment Tax Credit Claims for Tax Years 1999-2010	20
Exhibit 2.5	Estimated Research Tax Credit Claims for Tax Years 2000-2009	20
Exhibit 2.6	High-Technology Business Investment Tax Credit Claims for Tax Years 1999 Through 2008.....	21

Exhibit 2.7	Maximum Investment Credit Allowable Under Act 221	22
Exhibit 2.8	Number of High-Technology Business Investment Tax Credit Claims for Tax Years 1999 Through 2008	22
Exhibit 2.9	Number of Research Activities Tax Credit Claims for Tax Years 2000 Through 2006.....	23
Exhibit 2.10	Number of Audits Performed Compared With Number of High-Technology Tax Credit Claims for Tax Years 2001 Through 2008	35
Exhibit 2.11	Number of New High-Technology Tax Credits Selected for Audit (by year) Compared With Number of High-Technology Tax Credit Claims (by tax year), 2001 Through 2004.....	35

Chapter 1

Introduction

This audit of the Department of Taxation's (DoTAX) administrative oversight of high-technology business investment and research activities tax credits was self-initiated pursuant to Section 23-4, Hawai'i Revised Statutes (HRS), which requires the State Auditor to conduct post audits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State of Hawai'i and its political subdivisions.

Background

Legislative history of high-technology business investment and research activities tax credits

High-technology business investment and research activities tax credits (tax credits) were created in Act 178, Session Laws of Hawai'i (SLH) 1999, as part of a broader effort by the State to stimulate the growth and development of high-technology industries in Hawai'i. The Legislature recognized that advances in telecommunications and information technology, and the explosive growth of the Internet presented significant opportunities for the state to develop and diversify its economy, opening global market opportunities to Hawai'i businesses. Although Act 178 contained eight initiatives, the tax credits would later become the hallmark of this legislation.

Each year, the tax credits were amended to encourage the continued growth and development of high-technology businesses and associated industries in Hawai'i. In 2001, additional incentives were put in place to set Hawai'i apart as a tech-friendly place to do business. Act 221 (SLH 2001) greatly enhanced the high-technology business investment tax credit to allow taxpayers to claim 100 percent (rather than 10 percent) of their investment in a qualified high technology business (QHTB).

Under Act 221, a taxpayer could claim a maximum investment credit of \$2 million over five years (35 percent in the year of investment up to \$700,000; 25 percent in the first year following the investment up to \$500,000; 20 percent in the second year up to \$400,000; and 10 percent each in the third and fourth years up to \$200,000). In addition, partial recapture of the tax credit (10 percent of the amount of the total tax credit claimed in the preceding two tax years) was also permitted under certain circumstances. Great latitude was given to the Department of Taxation to interpret and implement the law.

By 2004, the department began raising concerns over alleged abuse of the so-called Act 221 tax credits. Stating that approximately 20 percent of the tax credits may qualify as criminal abuse of the tax credit, the department director called for amendments to the law. That year, the Legislature sought to improve the tax credits by making the law easier to enforce. The law was amended to require taxpayers claiming the high-technology business investment and research activities tax credit to submit a written certified statement which identified the qualified investments or expenditures expended in the previous tax year and the amount of the credits claimed. Act 215 (SLH 2004) also extended the tax credits for five more years, through 2010.

The amendment also included reference to the *doctrine of economic substance and business purpose*, as well as an intention to apply such doctrine to a transaction with an investment tax credit allocation ratio greater than one and a half but not more than two of credit for every dollar invested and claimed. Businesses claiming a ratio greater than two would be required to substantiate economic merit and business purpose consistent with the law.

The 2007 Legislature had difficulty measuring the impact of the tax credits and therefore determined that added transparency was needed. It passed a bill that would become Act 206 (SLH 2007), which required QHTBs to submit an annual survey documenting pertinent information including investment, employment, job creation, wage, revenue, expense, and other information to the DoTAX under threat of penalty. The measure also required the disclosure of the names of companies benefitting from the credits.

The department was directed to use this added information to study the effectiveness of the tax credit and report the department's findings to the Legislature by September 1 annually. The act also required the department report to the Legislature by October 31, 2007, a summary of data submitted by QHTBs on Form N-317 for all previous years available.

Finally, Act 178 (SLH 2009) limited the fiscal impacts of the credits for the period between May 1, 2009 and December 31, 2010; disallowed tax credit carryover provisions for investments on or after May 1, 2009; and limited the credits to no more than a one to one ratio.

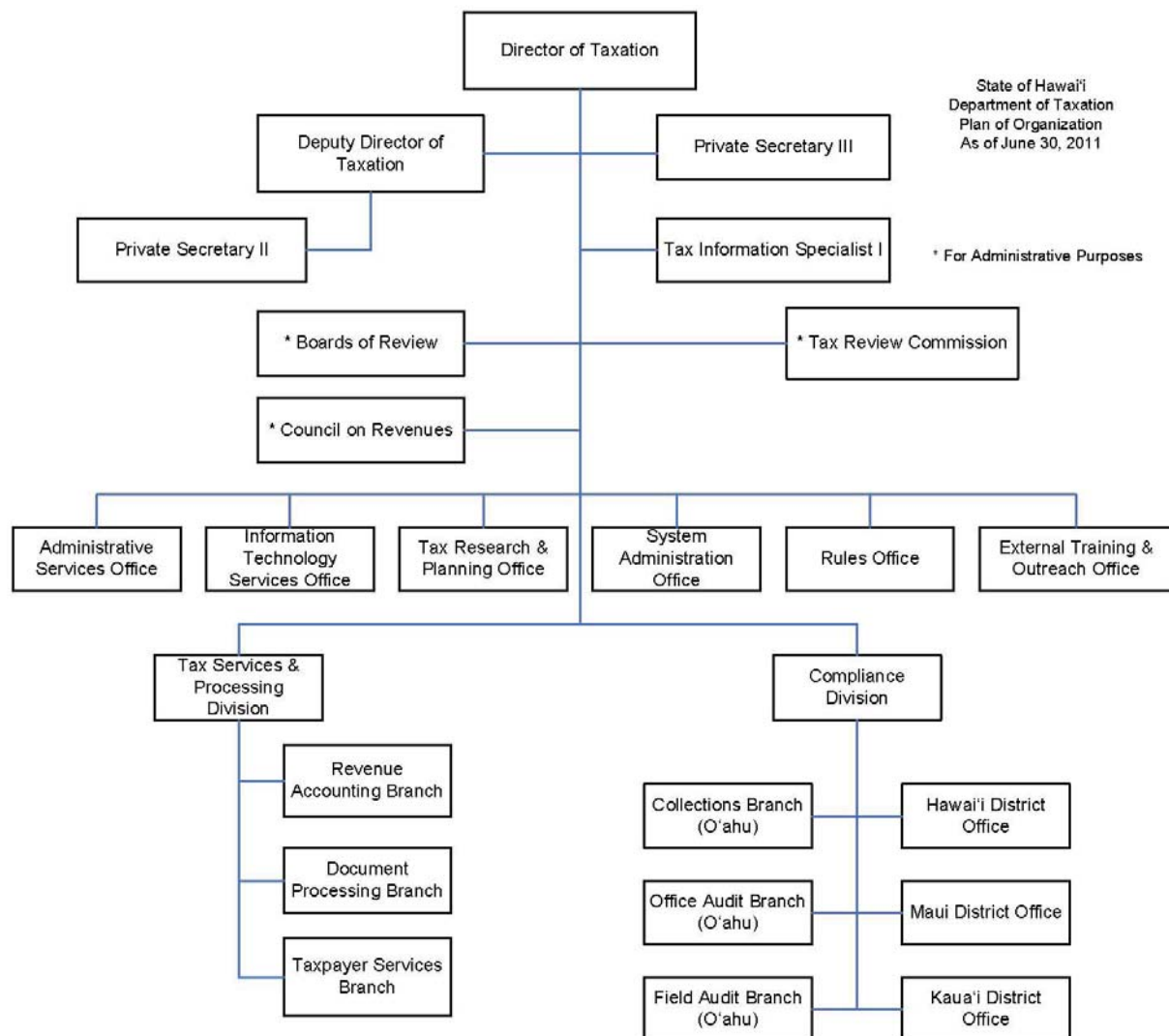
Department of Taxation mission and program operational structure

The Department of Taxation administers the high-technology business investment and research activities tax credits. The department's mission is "to administer the tax laws of the State of Hawai'i in a

consistent, uniform and fair manner.” The department is responsible for administering and enforcing tax revenue laws of the State and collecting all taxes and other payments payable thereunder.

The Department of Taxation is comprised of three key areas: the director and staff offices; the Tax Services and Processing Division; and the Compliance Division. The Council on Revenues, Tax Review Commission, and Boards of Review are administratively attached. Exhibit 1.1 displays the Department of Taxation’s organizational structure.

Exhibit 1.1 Department of Taxation Organization Chart



Source: Department of Taxation

The director and staff offices comprise all offices that report directly to the director of taxation, including: Rules Office, Information Technology Services Office, Tax Research and Planning Office, and Administrative Services Office.

The Rules Office serves as the resource for complex policy recommendations and complex taxpayer support. The Information Technology Services Office is responsible for the development, modification, and maintenance of the department's computerized tax systems, network, and related components. The Tax Research and Planning Office prepares analytical and statistical reports on department activities; forecasts of general fund tax revenues for state budget planning purposes; tax plans; and analytical reports on the revenue effects of proposed tax legislation.

The Tax Services and Processing Division performs all functions relating to the centralized processing, editing, and controlling of tax information through paper documents or electronic data; receiving, securing, depositing, and accounting for tax payments; and managing accounts, licensing, and providing taxpayer services to the public. The division consists of three branches: Document Processing, Taxpayer Services, and Revenue Accounting.

The objective of the Compliance Division is to maximize taxpayer compliance with Hawai'i's tax laws in a consistent, uniform, and fair manner. The division is composed of the O'ahu Office Audit, O'ahu Field Audit, and O'ahu Collections Branches, and the Maui, Hawai'i, and Kaua'i District Tax Offices.

High-technology business investment and research activities tax credits

High-technology business investment and research activities tax credits are established by provisions within the Hawai'i taxation law—Sections 235-110.9 and 235-110.91, HRS, respectively. The high-technology business investment tax credit is a *non-refundable* tax credit that is applied against a taxpayer's tax liability and may be carried forward to future years.

The investment tax credit is generous in that it allows taxpayers to claim 100 percent of their investment up to certain statutorily established thresholds per year and \$2 million over five years. Moreover, because the thresholds are not limited to investments in only one qualified high technology business, taxpayers can maximize tax credits by investing in more than one qualified business. For investments made on or after May 1, 2009, however, the credit was scaled back to no more than 80 percent of the taxpayer's tax liability, and the law disallowed credit carryovers.

The tax credit for research activities, on the other hand, is a *refundable* tax credit. Thus, even if a taxpayer does not have tax liability, a refund is issued. The amount of research tax credit that can be claimed each year is equal to 20 percent of the company's qualified research expenditures.

Both provisions sunset in December 2010; however, because the investment tax credits may be claimed over a five-year period, investor-taxpayers could continue to claim such credits through taxable year 2014. In addition, the excess of investment tax credit over tax liability may be used as a credit against the taxpayer's income tax liability in subsequent years until exhausted.

Administration of the tax credits

Three main areas within the department have responsibilities relating to the credits: the Rules Office, Tax Research and Planning Office, and Compliance Division.

The Rules Office prepares tax information releases on tax credits and develops and revises tax forms and instructions. The office also issues *certificates* for investors and QHTBs to claim tax credits for investments and research activities made during the prior year. In addition, the office issues *comfort letters*, which are used by QHTBs to assure investors that their investments would qualify for the high-technology business investment tax credit.

The Tax Research and Planning Office annually reports and evaluates the impacts of the high-technology business investment and research activities tax credits. The Compliance Division conducts all taxpayer audits.

Tax Administration Special Fund

Act 215 (SLH 2004) established the Tax Administration Special Fund. Among other purposes, this fund offsets costs associated with administering high-technology business investment and research activities tax credits. Revenues into this fund are derived from fees paid by taxpayers requesting comfort letters and certifications and moneys collected by the Special Enforcement Section. Allowable expenses from this fund are costs associated with administering the high-technology business tax credit law and for the administration and operation of the Special Enforcement Section.

Qualified high technology businesses

A *qualified high technology business* is a business that employs or owns capital or property in Hawai‘i, or maintains an office in Hawai‘i, and meets either the *activity test* or the *gross income test*:

- To meet the *activity test*, more than 50 percent of the business’s total business activities must be qualified research and more than 75 percent of the qualified research must be conducted in Hawai‘i.
- To meet the *gross income test*, more than 75 percent of the business’s gross income must be derived from qualified research, and the income from this qualified research must be received from:
 - a. Products sold from, manufactured, or produced in Hawai‘i; or
 - b. Services performed in Hawai‘i.

As shown in Exhibit 1.2, a total of 419 QHTBs have filed the department’s statement of QHTB (Form N-317) since the statement form was introduced for the 2002 reporting period. Of these, 133 (31.7 percent) specified that their qualifying activity was computer software development; 99 (23.6 percent) specified multiple activities; 89 (21.2 percent) specified performing arts activities; 31 (7.4 percent) stated they were involved in biotechnology activities; 31 (7.4 percent) were involved in non-fossil fuel energy-related technology activities; and six (1.4 percent) were involved in ocean sciences activities.

Exhibit 1.2
Cash Investment Received by 419 QHTBs, by Year

Activity	Number of QHTBs Filing Form N-317		Cash Investment	
	2002 - 2009	2009	2000 - 2009	2009
Research as in IRC Sec. 41(d)	30	12	\$124,555,928	\$5,540,000
Biotechnology	31	15	\$79,838,645	\$4,278,104
Computer Software	133	35	\$236,347,023	\$14,308,279
Non-fossil Fuel Energy	31	15	\$137,329,612	\$9,805,808
Performing Arts	89	44	\$659,946,370	\$105,148,104
Ocean Sciences	6	2	\$26,215,752	\$260,000
Multiple Activities & Others	99	40	\$440,613,054	\$18,156,100
TOTAL	419	163	\$1,704,846,384	\$157,496,395

Note: The number of QHTBs and cash investment in the 2009 columns are included in the 2002-2009 totals.

Source: Department of Taxation

The total possible *additional* credits that could be claimed by investors in these companies is \$847.2 million. The State remains obligated to honor these tax credit claims, thus reducing the State's potential revenues over at least the next four years.

Tax credit forms

The department developed various forms to report and implement the high-technology business investment and research activities tax credits. Businesses use Form N-317, *Statement by a Qualified High Technology Business (QHTB)*, an annual survey, to report investment, employment, job creation, wage, revenue, expense, and other information by June 30 of each calendar year following the five calendar years in which the credit for the investment is claimed.

For both credits, there is a narrow window of time for taxpayers to file—and the department to issue—certified statements of the amount of the tax credit for each taxable year and cumulative amount of the tax credit. Taxpayers have until March 31 of each year in which an investment was made or qualified research or development activity was conducted in the prior year to file with the department for a certificate verifying the information, which certificate must then be filed with the taxpayer's tax return in April.

To claim the tax credits, taxpayers first obtain the certificate using Forms N-318A and N-319A. The certificate is attached to the taxpayer's Form N-318 and N-319, reported on Schedule CR, and filed as part of the taxpayer's tax returns. The relevant forms are listed below:

- Form N-318, *High Technology Business Investment Tax Credit*: Used to claim the nonrefundable high technology investment tax credit.
- Form N-318A, *Certified Statement of Investment in a QHTB and Claim of the High Technology Business Investment Tax Credit*: The certified statement of investment in a QHTB.
- Form N-319, *Tax Credit for Research Activities*: Used to claim the research activities tax credit.
- Form N-319A, *Certified Statement of Research and Development Costs Incurred by a QHTB and Claim of the Tax Credit for Research Activities*: The certified statement of research and development costs incurred by a QHTB.
- Schedule CR, *Schedule of Tax Credits*: Schedule of all nonrefundable and refundable tax credits, including the high technology business investment and research activities tax credits.

Prior Audits

In 2010, we conducted an audit of the Department of Taxation contracts. In Report No. 10-11, *Management and Financial Audit of Department of Taxation Contracts*, we found poor leadership, internal management strife, and inadequate project management training in the department. Further, the department failed to establish and implement an IT strategic plan. The report also noted the then-director of taxation placed constraints on our access to both department documents and staff.

Objectives of the Audit

1. Assess the adequacy of the Department of Taxation's planning and implementation of the high-technology business investment and research activities tax credits.
 2. Assess the effectiveness of the department's processing, monitoring, and reporting of the high-technology business investment and research activities tax credits.
 3. Make recommendations as appropriate.
-

Scope and Methodology

This audit focused on the department's planning and implementation of the high-technology business investment and research activities tax credits for the calendar years 2007-2011. We included prior years from 1999 as necessary. We conducted interviews with the department managers and staff involved in the administration of the tax credits, as well as legislators, other agencies, and individuals as required. Our audit included a review of policies and procedures, reports, training, and any other documents and records to assess and evaluate the department's effectiveness in its planning and implementation of the tax credits.

Auditor's authority to access information

The Office of the Auditor has broad authority to access information. Section 23-5, HRS, gives the Auditor authority to examine and inspect all accounts, books, records, files, papers, and documents and all financial affairs of every department, office, agency, and political subdivision. Further, Section 92F-19, HRS, of the *Uniform Information Practices Act*, requires agencies to share records with the Office of the Auditor. The administration's withholding of records from our office during this audit is in contravention to the law and prevents the Auditor from carrying out her constitutional and statutory audit authority.

Auditor's access to information

Throughout our audit we requested department information and documents. A request for documents is standard procedure during the preliminary planning phase and fieldwork of an audit. However, we did not receive some of the documents requested. For example, we requested documents from the department on March 19, 2012. The department did not make the information available to us and responded that its officials are determining what can be released to our office. We made multiple assurances to the department that we were not interested in taxpayer information and that the contents of our workpapers are confidential by statute. As of May 8, 2012, the department has not provided the documents requested.

Audit standards

We were also restricted access to various DoTAX work areas because of concerns that we would be put in contact with taxpayer information. As a result, we amended our audit procedures to accommodate department restrictions. For example, we were required to request department documents rather than pull the information ourselves. In some cases, our work was limited to interviews and review of redacted documents produced by the department. At times, we were not granted access to data and were thus unable to independently validate and verify some information.

Our audit work was conducted from January 2012 to May 2012 according to the Office of the Auditor's *Manual of Guides* and generally accepted government auditing standards (GAGAS). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

This page is intentionally left blank.

Chapter 2

DoTAX Struggled To Manage a Deficient High-Technology Tax Credit Law

In 1999, the Legislature’s vision was to grow a high-technology industry here in Hawai‘i. The law it enacted, however, fell short of establishing a vehicle that would both create and account for high-technology business investment and research activities tax credits. The law was deficient, silent as to the expectations of the Department of Taxation (DoTAX), and caused the department’s responsibilities to grow. Lacking specific direction, DoTAX implemented the high-technology tax credits as it had all tax credits. Moreover, the law did not provide the means to measure and evaluate the tax credits and did not foresee the need to lift taxpayer confidentiality requirements. The department struggled to manage the deficient law, resulting in inadequate and unreliable processing, monitoring, and reporting of the high-technology tax credits. Ultimately, DoTAX reports may mislead policymakers in their decisionmaking.

Summary of Findings

1. Lacking statutory directives to do otherwise, DoTAX implemented high-technology business investment and research activities tax credits as it had all tax credits. However, as the tax credits evolved over time, the department’s responsibilities grew.
2. The department’s processing, monitoring, and reporting of the high-technology business investment and research activities tax credits are inadequate, unreliable, and lack transparency.

A Deficient High-Technology Tax Credit Law Provided No Guidance to DoTAX

The high-technology business investment and research activities tax credits have cost the State almost \$1 billion, yet the State can neither measure nor assess their effectiveness. No one knows whether the tax credits were successful or met their purpose.

Due to a poorly designed law, the high-technology tax credits escape accountability. The Legislature utilized the tax credits as a tool to accomplish its policy goal—in this case, to support the growth of the high-technology industries in Hawai‘i. However, we found that the high-technology tax credit law and its subsequent amendments lacked the means to measure the effectiveness and were silent as to the expectations of the Department of Taxation, which was tasked with implementing the tax credits. First, no goals or performance measures were established to

measure the effectiveness of the tax credits and address the disclosure of taxpayer information, which was needed to ensure meaningful reporting. Second, we found that other states with similar tax credits are administered outside their taxation departments, and their reporting requirements mandate disclosure of taxpayer information by law. Third, the numerous amendments to the law increased the number of tax credit claims and gave DoTAX more administrative responsibilities related to the tax credits. For example, the department was tasked to issue certifications and comfort letters, and report separately on the effectiveness of the tax credits. In addition, because DoTAX did not have the expertise to conduct audits on complex tax credits, it needed to procure the services of subject matter experts to provide technical expertise and assistance. Finally, because the law did not direct it to do otherwise, DoTAX implemented the high-technology tax credits as it had all tax credits—it issued forms and guidance, audited taxpayer returns, and reported on the credits in its existing reports.

Measurement of tax credit success was impracticable without goals, performance measures, and disclosure of taxpayer information

Tax expenditures, including tax credits, are not part of the state budget, not appropriated, and claims can be unlimited. Thus, the ability to measure and report on tax expenditures is important and provides accountability. We found, however, that the high-technology business investment and research activities tax credits law did not contain any goals and performance measures. Unable to measure their success nor ensure their effectiveness, the State does not know whether the tax credits accomplished their policy goal to support the growth of the high-technology industries in Hawai‘i.

According to the Center on Budget and Policy Priorities, *Promoting State Budget Accountability Through Tax Expenditure Reporting, May 2011*, tax expenditures are tax credits, deductions, and exemptions that reduce state revenue. They are a form of spending but are much less transparent than direct expenditures. Direct expenditures are part of a state budget that include the spending for a current year and proposed spending for the coming year. The legislature then enacts the budget. However, tax expenditures are not listed in the budget. As a result, they are much less likely than spending items to be analyzed, debated, and weighed against other priorities as the legislature prepares the final budget.

Further, tax expenditures are not appropriated each year. Appropriated expenditures generally last only as long as the one- or two-year budget cycle. Tax expenditures, by contrast, are typically permanent unless revoked and generally escape the accountability to which direct spending is subjected. Moreover, deductions and credits typically can be claimed by an unlimited number of taxpayers and sometimes in unlimited amounts. Because the cost of tax breaks is not in the budget, this growth

can happen without the Legislature's knowledge. It is thus imperative that tax expenditures—in this case, high-technology tax credits—are measured and reported for accountability.

We compared best practices to Hawai'i's law and its subsequent amendments and found them to be sorely deficient. First, the law did not contain any goals and performance measures. According to the Government Finance Officers Association (GFOA), *Developing an Economic Development Incentive Policy 2008*, at a minimum an economic development policy should contain goals and performance standards. Goals and measurable objectives create a context and accountability for the use of economic development incentives. Performance standards help a jurisdiction gauge the effectiveness of its overall economic development program. Second, we found that the law did not contain an evaluation process until 2007, when it required DoTAX to measure the effectiveness of the tax credits. The association's best practices state that a clearly defined evaluation process should be outlined in an economic policy for the purposes of consistency and transparency. Lastly, as suggested by GFOA, the law did not contain monitoring and compliance elements and a process to regularly monitor whether the goals for each project are achieved within the defined timeframe. We conclude, however, since the monitoring and compliance function would be part of DoTAX's operational process, it need not be addressed in the law.

Thus, identifying goals at the beginning of a policy lays a foundation for later measurement and evaluation. Exhibit 2.1 compares the amendments to the law against GFOA best practices.

We also found that prior to 2007, the law was silent on lifting confidentiality and disclosing taxpayer information for reporting purposes. According to Section 235-116, HRS, all tax returns and return information is confidential. Therefore, DoTAX could report on the tax credits only in the aggregate because it was not allowed to disclose taxpayer information. In 2007, the Legislature amended the law to allow disclosure of the names of companies benefitting from the credits. The law, however, did not go far enough to lift taxpayer confidentiality in the areas of identifying individual taxpayers' names and the amount of tax credits issued to companies benefitting from the credits. By mandating disclosure of this information, the law would have provided needed transparency and enabled robust reporting on the tax credits.

**Exhibit 2.1
Comparison of Law Amendments With GFOA Best Practices**

GFOA Best Practices	Amendments to Law					
	Act 178 SLH 1999	Act 297 SLH 2000	Act 221 SLH 2001	Act 215 SLH 2004	Act 206 SLH 2007	Act 178 SLH 2009
Goals	None	None	None	None	None	None
Performance standards	None	None	None	None	None	None
Evaluation process	None	None	None	None	Some	None
Monitoring and compliance	None	None	None	None	None	None

Note: Session Laws of Hawai'i (SLH)
Source: Office of the Auditor

Other states have enacted similar investment tax credits

At least 25 states offer investment tax credits that are roughly comparable to the Hawai'i high-technology business investment tax credits, with Hawai'i's 100 percent tax credit well above the level offered in any other state. Maine had a 60 percent tax credit rate. New Jersey had the lowest, at 10 percent.

For individual annual tax credit caps, Hawai'i was the highest, at \$2 million per business annual tax credit cap. Indiana, Illinois, and New Jersey followed at \$500,000. Colorado was the lowest, at \$20,000. Individual, annual caps for other states generally ran between \$50,000 and \$250,000. In Arkansas, the credit could not exceed 50 percent of tax liability. Iowa and Wisconsin had no individual annual tax credit cap, but Iowa had a \$10 million statewide total credit cap, which it reached in 2008, and Wisconsin had a \$20 million statewide total annual credit cap.

Hawai'i does not have a statewide total tax credit cap on the amount or value of the investment tax credits that can be generated annually or on a program basis. New Jersey and Oklahoma also did not have a statewide cap. Colorado and New Mexico had the lowest, at \$750,000 (Colorado only for the year 2010, and New Mexico per year). Most states have an annual or statewide or program total tax credit cap for the credits. Exhibit 2.2 shows the range of investment tax credits for selected states.

Exhibit 2.2
Comparison of Selected States' Investment Tax Credits

	State	Name of Credit (TC-Tax Credit)	Credit Rate	Individual Cap	Total Statewide or Program Cap (M-Millions)
1	Arkansas	Capital Development Co. Income TC	33 1/3%	Credit cannot exceed 50% of tax liability	\$5M/year from CYs 2003-21, additional \$1.25M with director's approval
2	Colorado	Innovation Investment TC	15%	\$20,000/year	\$750,000 in 2010
3	Hawai'i	High-Tech Investment TC	100%; 80% effective 5/1/2009	\$2M/business	None noted
4	Illinois	Angel Investment Credit	25%	\$2M/investment (or \$500,000/business calculated at 25% of \$2M)	\$10M/CY
5	Indiana	Venture Capital Investment TC	20%	\$500,000/year/business	\$12.5M/year
6	New Jersey	High-Tech Investment TC	10%	\$500,000/year/investment or 50% of total tax liability	None noted
7	New Mexico	Angel Investment Credit	25%	\$25,000/year/investment up to two investments/year	\$750,000/CY
8	Oklahoma	Small Business Capital Credit	20%	200% of qualified investment (e.g., for \$1M investment, credit is limited to 20% of \$2M or \$400,000)	None noted
9	Rhode Island	Innovation TC	50%	\$100,000/total/carried forward 3 years	None noted
10	Wisconsin	Angel Investment TC	25%	None noted	\$6.5M in CY2010; \$20M/CY thereafter

Source: Office of the Auditor

Other states administer similar high-technology tax credits outside their taxation departments

In our review of other states' tax credit programs, we noted that most of the states' tax credit programs are administered outside the taxation, revenue, and finance departments. In 17 states, we found that the tax credits are administered by the economic development and/or commerce departments. In one state—Connecticut—we found that the tax credits are administered by a quasi-public authority on behalf of the state.

We also found that other states such as Minnesota and Rhode Island have specific reporting requirements written in their statutes to make the names and addresses of qualified businesses and investors and the amount of investments and credits public data. For example, Minnesota's 2011 annual report on the angel tax credit program disclosed the names of the qualified business receiving investments, investment amount, and credits issued. It also listed the names of the investors that

have been certified as qualified investors. Minnesota’s statute makes this information public data. Exhibit 2.3 shows tables from Minnesota’s 2011 annual report on the angel tax credit program, which reveal vast amounts of taxpayer data that is classified as confidential in Hawai‘i.

**Exhibit 2.3
Tables From Minnesota’s 2011 Report on Angel Tax Credit Program Revealing Taxpayer Information**

**Minnesota Angel Tax Credit
List of Credits Issued**

The following businesses have received investments that have qualified for Angel Tax Credit certificates under Minn. Stat. 116J.8737. Issuance of these certificates solely means that Department of Employment and Economic Development (DEED) has found that the investment meets the qualifications specified in the statute and that the qualified investor or qualified fund’s investor are being awarded tax credits under DEED’s Angel Tax Credit Program. Minn. Stat. 116J.8737, Subd. 8, paragraph (a) makes this public data.

Businesses Receiving Investments through the Angel Tax Credit Program in 2011

Business Name	Investment Amount	Credits Issued
3D Sports Technology, Inc.	\$ 320,000.00	\$ 80,000.00
7 Ventures, LLC	\$ 2,250,000.00	\$ 562,500.00
ABS Corporation	\$ 480,500.00	\$ 120,125.00
Accelerated Innovations, LLC	\$ 1,000,000.00	\$ 250,000.00
ActiFi, Inc.	\$ 25,000.00	\$ 6,250.00
Advanced Healing Systems, Inc.	\$ 50,625.00	\$ 12,656.25
Advanced Vein Therapy, Inc.	\$ 10,000.00	\$ 2,500.00
Advanze Cardio Systems, LLC	\$ 1,000,000.00	\$ 250,000.00
Agristrand Mankato, LLC	\$ 4,000,000.00	\$ 1,000,000.00
Anser Innovation, LLC	\$ 240,000.00	\$ 60,000.00
Applied Bioprocess Containers, LLC	\$ 1,726,197.00	\$ 431,549.25
Argos Risk, LLC	\$ 796,090.00	\$ 199,022.50
Aria CV, Inc.	\$ 225,000.00	\$ 56,250.00
AsystMe, LLC	\$ 322,500.00	\$ 80,625.00
AtPlayMusic, LLC (f/k/a AnimaToPlay, LLC)	\$ 187,500.00	\$ 46,875.00
AUM Cardiovascular, Inc.	\$ 450,000.00	\$ 112,500.00
Bio-Plastic Solutions, LLC	\$ 80,000.00	\$ 20,000.00
Bioactive Regenerative Therapeutics, Inc	\$ 35,000.00	\$ 8,750.00
Biogenic Reagents	\$ 3,999,928.00	\$ 999,982.00
BioMagnetic Sciences, LLC	\$ 636,000.00	\$ 159,000.00
BioMatRx, LLC	\$ 100,000.00	\$ 25,000.00
Biovation, LLC	\$ 167,000.00	\$ 41,750.00
Brilliant Nations Corporation	\$ 73,000.00	\$ 18,250.00

Minnesota Angel Tax Credit List of Qualified Investors

The following investors have been certified as Qualified Investors under Minnesota Statute 116J.8737. This certification solely means that Minnesota Department of Employment and Economic Development (DEED) has found that each investor meets the qualifications specified in Subdivision 3 of the statute and that each investor is therefore eligible to participate in DEED's Angel Tax Credit Program.

2011 Qualified Investors

Abbott, David	Abbott, Patricia A.
Abena, Anthony C.	Aber, Jerry P.
Akhtar, Jamiel A.	Akhtar, Syed T.
Al-Dorraj, Harit H.	Al-Fayadh, Mojahid H.
Alford, James L.	Allaei, Daryoush
Aldredge, William C.	Al-Samarrai, Jafar S.
Anderson, Dana E.	Anderson, Daniel W.
Anderson, Jeffrey R.	Anderson, Mark J.
Anderson, Mark S.	Anderson, Richard H.
Arvidson, Curt E.	Asamarai, Abdulwahab M.
Asamarai, Saeb S.	Auth, David C.
Baarsch, Katherine E.	Bagley, David A.J.
Baken, Leslie A.	Ballin, Andrew R.
Bang, Gary R.	Banning, J.B.
Baratz, Stanford	Bares, Keith S.
Barry, Charles L.	Barry, Michael E.
Barsky III, Joseph M.	Basara, James J.
Basman, Neville	Beenken, Daniel W.
Beenken, Joel D.	Beenken, Nathanael W.
Beenken, Seth E.	Behm, James D.
Benedict, Gregory L.	Bercaw, Charles C.
Berge, Donald	Berge, Ivar
Bergstrom, John C.	Berman, Michael
Berndtson, Elaine M.	Bernhard, Kevin T.
Bernhard, Philip A.	Bernhard, Timothy P.
Bierstedt, George A.	Birr, Barbara J.
Bish, Joyce L.	Blake, Mary P.
Blanchard, John A.	Block, James C.
Boecker, Ronald F.	Bollig, Mark A.
Bonham, James A.	Bonnett, Timothy J.
Borman, Mark P.	Bowen, Betsy B.
Boysen, Helen R.	Brabeck, Michael A.
Bracken, Margaret A.	Brandt, Larry M.
Brekhus, Todd R.	Breon, John L.

Minnesota's statute makes the following information public:

- (1) the name of a qualified small business or qualified investor upon approval of the application and certification by the commissioner;
- (2) the name of a qualified fund upon approval of the application and certification by the commissioner; and
- (3) for credit certificates issued, the amount of the credit certificate issued, amount of the qualifying investment, the name of the qualifying investor or qualifying fund that received the certificate, and the name of the qualifying small business in which the qualifying investment was made, etc.

Further, the statute requires that the annual report include: the number and amount of the credits issued; the recipients of the credits; for each qualified small business, its location, line of business, and if it received an investment resulting in certification of tax credits; the total amount of investment in each qualified small business resulting in certification of tax credits; and for each qualified small business that received investments resulting in tax credits, the total amount of additional investment that did not qualify for the tax credit, among other information.

Although Hawai'i's Act 206, SLH 2007, added reporting requirements that allowed DoTAX to disclose the names of the QHTBs, the Legislature needed additional information for reporting purposes such as the names of the investors, the amount of investment and/or credits QHTBs received. The Legislature can do so through statutorily requesting the information as part of DoTAX reporting requirements and lifting taxpayer confidentiality as other states have done.

High-technology tax credits evolved over time due to statutory amendments

The high-technology tax credit law was enacted in 1999 and sunset in 2010. During that time, the Legislature amended the law by altering it in fundamental ways: changing the claimable amount; redefining terms; adjusting the nature of the credits; and extending the applicable years, among other amendments. By the time of their repeal, the resulting tax credits were very different from those originally enacted in 1999.

Initially, the high-technology business investment tax credit was a nonrefundable tax credit equal to 10 percent of the investment in each qualified high technology business, with a maximum of \$500,000 for the taxable year. Because it was a nonrefundable credit, the amount of the allowable credit used could not exceed the taxpayer's tax liability for

that year. Taxpayers were allowed to carry forward the excess credits in subsequent years until used in their entirety, unless the investment was made on or after May 1, 2009. In 2001, the tax credit was increased from 10 to 100 percent, claimable over five years with a maximum of \$2 million per investment per QHTB, quadrupling the allowable amount per investment. Although the law limited taxpayers to a cumulative total of \$2 million per investment, the law did not provide a maximum total cumulative amount of tax credits available to taxpayers. Thus, taxpayers could potentially invest multiple times in multiple QHTBs and claim the \$2 million maximum multiple times. The amount of tax expense to the State was unlimited.

Statutory amendments in 2001 expanded the definition of qualified research by allowing other types of research to qualify. When enacted in 1999, the investment credit limited qualified research to the same as provided in section 41(d) of the Internal Revenue Code or developing, designing, modifying, programming, and licensing of computer software. The following year, however, the Legislature redefined qualified research by changing the description of qualifying computer software activities, adding biotechnology, and removing the exception regarding research conducted outside the state. In 2001, the Legislature further expanded qualified research to include performing arts products (audio and video file, computer animation, movies and TV), sensor optics technologies, ocean sciences, astronomy, and non-fossil fuel energy-related technology.

Similar to the high-technology credit, the research activities tax credit started as a nonrefundable credit. The amount of the tax credit was limited to 2.5 percent of the excess of qualified research expenses for the tax year, over the base amount. In 2000, however, the law was amended to make the research activities credit refundable, meaning that any portion of the credit that remains after the credit is applied to the income tax is refunded to the taxpayer. That same year, the research activities tax credit was increased to 20 percent of the excess expenditure over previous tax years. Subsequently, the law expanded the research credit to include all qualified research expenditures, not just those expenditures that exceeded the expenditures from previous tax years. In 2004, the law limited the credit to only QHTBs by deleting taxpayers.

Lastly, in 2004, the law was amended to extend the tax credits for an additional five years, from December 31, 2005 to December 31, 2010.

The changes in the law over the years led more taxpayers to claim the high-technology tax credits, resulting in an increase in the amount of tax credits claimed. In the early years—for example, in tax year 2001—only 268 and 118 tax returns claimed the high-technology business investment and research activities tax credits, respectively. Collectively, they represented .09 percent of the total taxpayer returns with tax credits claimed, adding up to \$22 million.

By tax year 2005, the last tax year for which the department reported on tax credits claimed, 1,219 and 224 tax returns claimed the high-technology business investment and research activities tax credits, respectively. Collectively they represented almost .62 percent of the total taxpayer returns with tax credits claimed and about \$83 million, making them the most lucrative tax credits claimed.

High-technology tax credits have cost the State almost \$1 billion

The department estimated the high-technology business investment tax credit cost the State of Hawai‘i a total of \$857.6 million in lost tax revenues since the inception of the program in 1999 through tax year 2010. Research activities tax credits have cost the State an additional \$112.5 million for a total of \$970.1 million. Exhibit 2.4 shows the estimated investment tax credit claimed for tax years 1999–2010, as reported by the department. The department also estimated the research activities tax credit cost the State a total of \$112.5 million in lost tax revenues for tax years 2000–2009, as shown in Exhibit 2.5.

**Exhibit 2.4
Estimated Investment Tax Credit Claims for Tax Years 1999–2010**

Cumulative Investment Tax Credit Claimed, Tax Years 1999 - 2008	\$559,559,247
Estimated Investment Tax Credit Claims, Tax Year 2009	\$119,200,000
Estimated Investment Tax Credit Claims, Tax Year 2010 *	\$178,800,000
Total Investment Tax Credit Claims, Tax Years 1999 - 2010	\$857,559,247

* This \$178.8 million is an estimate of carryovers and years 2 to 5 credits for investment made prior 2010. This estimate does not include new investments that may be made in the same companies in calendar year 2010.

Source: Department of Taxation

**Exhibit 2.5
Estimated Research Tax Credit Claims for Tax Years 2000–2009**

Cumulative Research Credit Claimed, Tax Years 2000 - 2008	\$101,696,516
Estimated Research Credit Claims, Tax Year 2009 1/	\$10,850,275
Total Research Credit Claims, Tax Years 2000 - 2009	\$112,546,791

1/ Research Credit Claims as reported by 163 QHTBs in the 2009 Form N-317s.

Source: Department of Taxation

Exhibit 2.6 reflects the break out of the high-technology business investment tax credit claims per year from 1999 to 2007, including preliminary numbers for 2008.

Exhibit 2.6
High-Technology Business Investment Tax Credit Claims for Tax Years 1999 Through 2008

Year	Total No. of Claims	Total Credit	Individuals	Corporations	Financial Corporations ²	Insurance Underwriters	Fiduciaries	Exempt Organizations
1999	23	\$162,208	N/A	N/A	N/A	N/A	N/A	N/A
2000	103	393,633	N/A	N/A	N/A	N/A	N/A	N/A
2001	268	9,579,923	\$3,334,260	\$225,205	\$4,209	\$6,013,757	\$2,492	N/A
2002	493	26,185,181	11,191,036	1,710,041	N/A	13,057,896	226,208	N/A
2003	652	38,870,301	13,360,232	3,855,197	2,100,658	19,391,764	162,450	N/A
2004	1,040	50,543,285	26,858,573	994,571	1,599,658	20,714,206	376,277	N/A
2005	1,216	69,827,709	38,111,997	3,428,405	2,286,892	25,293,046	700,845	\$6,524
2006	1,842	105,407,136	59,622,619	8,471,761	10,146,111	26,732,870	431,802	1,973
2007	2,235	140,139,109	82,717,224	9,478,054	15,669,335	29,913,337	2,336,416	24,743
2008 ³	2,488	121,200,553	67,361,978	9,605,761	10,737,197	30,193,343	3,298,623	3,651
Totals	10,360	\$562,309,038	\$302,557,919	\$37,768,995	\$42,544,060	\$171,310,219	\$7,535,113	\$36,891

¹Tax Credit actually used (deducted from Hawai'i income taxes due).

²Financial corporations are defined as corporations that file Form F-1, the Franchise Tax return.

³Unaudited data.

Note: We noted differences in the department's reporting with no explanation provided.

Source: Department of Taxation, Tax Research and Planning Office

As the tax credits evolved, DoTAX responsibilities grew

As the Legislature amended the high-technology tax credit law over time, DoTAX responsibilities grew. We found that the statutory amendments increased the amount of tax credits claimed and required DoTAX to certify the tax credits, issue comfort letters, and report on the measures of effectiveness of the tax credits. Further, the department's audits involving the tax credits were complex.

Taxpayers claimed more tax credits after business investment tax credit expanded from 10 to 100 percent and research activities became refundable

When enacted in 1999, the high-technology business investment tax credit was limited to 10 percent of the investment in each qualified high technology business, with a maximum of \$500,000 for the taxable year. It remained at this rate for tax years 1999 and 2000, and in those years, there were only 23 and 103 claims made, respectively. Anecdotally, a department official shared that at 10 percent, the credit was "not popular." In tax year 2001, however, the credit was expanded from 10

to 100 percent, claimable over five years with a maximum of \$2 million per investment per QHTB as shown in Exhibit 2.7. Thereafter, the department reported a marked increase in the number of claims.

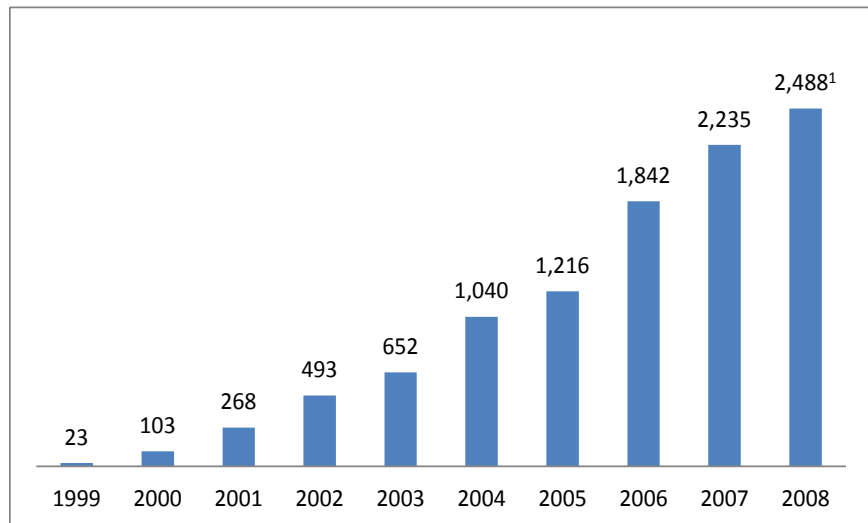
**Exhibit 2.7
Maximum Investment Credit Allowable Under Act 221**

Year of investment	35% of \$2M =	\$700,000
1st year following year of investment	25% of \$2M =	\$500,000
2nd year	20% of \$2M =	\$400,000
3rd year	10% of \$2M =	\$200,000
4th year	10% of \$2M =	<u>\$200,000</u>
	TOTAL	\$2,000,000

Source: Office of the Auditor

In its December 2010 report, *The Impact of the High Technology Business Investment Tax Credit on Hawai‘i’s Economy for Calendar Year 2009*, DoTAX reported that the total number of claims in tax year 2000 (103 claims) more than doubled in tax year 2001 (268 claims), and almost doubled again in tax year 2002 (493 claims). Claims continued to increase in tax years 2003 (652 claims); 2004 (1,040 claims); 2005 (1,216 claims), and onward through 2008. Exhibit 2.8 displays the high-technology business investment tax credit claims for tax years 1999 through 2007, and preliminary numbers for 2008.

**Exhibit 2.8
Number of High-Technology Business Investment Tax Credit Claims for Tax Years 1999 Through 2008**



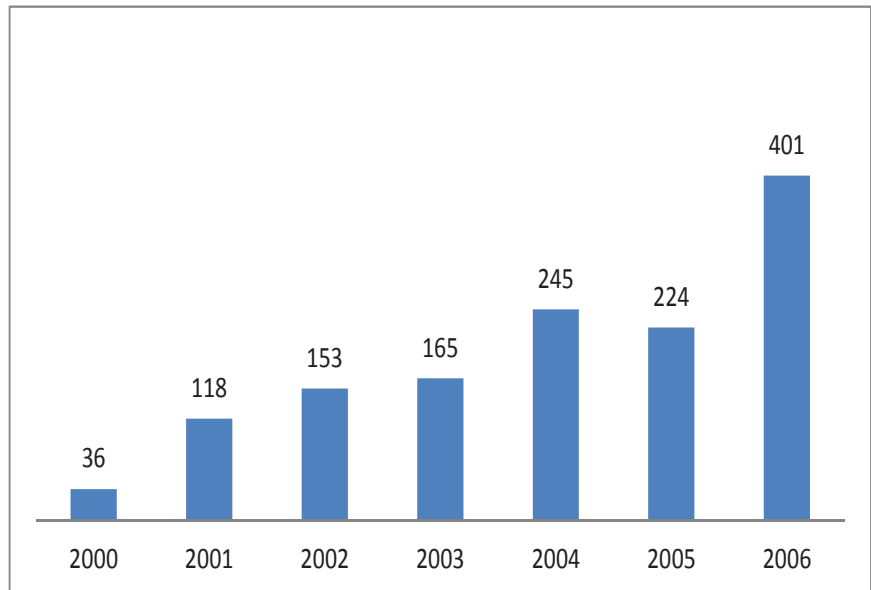
¹Unaudited data.

Source: Department of Taxation, Tax Research and Planning Office

The research activities tax credit that was created in 1999 was not applicable for that tax year. However, in the following year, the research activities tax credits became refundable and the amount increased from 2.5 percent to 20 percent of the excess expenditures over previous tax years.

In its December 2008 report, *The Impact of the High Technology Business Investment Tax Credit on Hawai‘i’s Economy for Calendar Year 2007*, DoTAX reported that the total number of claims in tax year 2000 (36 claims) more than doubled in tax year 2001 (118 claims), and continued to increase in tax year 2002 (153 claims); 2003 (165 claims); and 2004 (245 claims). There was a slight decrease in tax year 2005 (224 claims); however, in tax year 2006, the credit rose significantly (401 claims). Exhibit 2.9 displays the research activities tax credit claims for tax years 2000 through 2006.

Exhibit 2.9
Number of Research Activities Tax Credit Claims for Tax Years 2000 Through 2006



Source: Department of Taxation, Tax Research and Planning Office

Taxpayer certifications were added in 2004

Act 215 (SLH 2004) added certification requirements for taxpayers claiming the credits to submit a certified statement to the department. We obtained and reviewed the certification logs from the Rules Office for 2005 through part of 2010 and noted that it issued 12,162 certifications. The law required that every taxpayer before March 31 of each year in which an investment in a QHTB was made in the previous tax year,

to submit a written, certified statement to the department identifying qualified investments and amount of tax credits claimed. It also required every QHTB before March 31 of each year in which qualified research and development activity was conducted in the previous tax year, to submit a written, certified statement to the department identifying qualified expenditures and amount of tax credit claims.

In addition to the certifications, the law authorized the collection of fees for the issuance of *comfort letters* and rulings and created the Tax Administration Special Fund to offset costs associated with issuing such letter rulings and certificates. Rulings, which may include comfort letters, inform potential investors that the business in question has received assurances from DoTAX that investments into the business will qualify for the tax credit. According to DoTAX 2005–2006 to 2009–2010 Annual Reports, it responded to a total of 246 requests for rulings on QHTB activities.

Mandates to report and study the effectiveness of high-technology tax credits were added in 2007

In 2007, the law was amended to require that DoTAX measure the effectiveness of the tax credits. Act 206 (SLH 2007) required QHTBs claiming the credits to provide to DoTAX with investment, job creation, revenue, and expense information. To implement the law, DoTAX prepared an electronic survey instrument (Form N-317) to collect the information and annually reported on the information in an aggregate form to the Legislature. The Tax Research and Planning Office was tasked to study the effectiveness of the tax credit and submit its findings to the Legislature. However, the department was given a short timeframe to summarize the data submitted on QHTBs for all previous years and submit a report to the Legislature by October 31, 2007. According to a department employee, data from 2002–2006 for the October 2007 reporting was submitted in hardcopy and manually compiled. This is the only tax credit that required separate reporting.

Moreover, the office stopped reporting on high-technology tax credits after tax year 2009 because the law sunset in 2010, and the department concluded that reporting was not needed. Thus, reports for tax year 2010 will not be generated although DoTAX has the raw data.

Taxpayer audits involving high-technology tax credits are complex

We found that the Compliance Division, Field Audit Branch required the assistance of subject matter experts (SME) to provide technical assistance and expertise due to the complexity of the high-technology tax credits. According to a 2009 request to the then-governor, the former

DoTAX director stated that the tax credit for research activities involves the review and interpretation of taxpayer technical documents and data that usually include scientific jargon and concepts unique to the industry. Since DoTAX auditors are not experts in current research efforts in the scientific industry, they required technical assistance. Noting that the DoTAX would be at a disadvantage if it did not have its own experts to dispute any erroneous claims made by the taxpayers' experts, the department indicated that SMEs would be also used as witnesses in tax appeal hearings that are often technical in nature, and taxpayers would bring their own technical experts. Therefore, SMEs were considered essential to ensuring high-technology tax credit audits resulted in accurate assessments when warranted, and that these assessments can be sustained in court.

According to the National Conference of State Legislatures' (NCSL) *Principles of a High-Quality State Revenue System*, there are nine principles of a high-quality state revenue system. Principle No. six states that a high-quality revenue system promotes fair, efficient, and effective administration; it is as simple as possible to administer; raises revenue efficiently; is administered professionally; and is applied uniformly. The department's need to use SMEs in auditing high-technology tax credits violates the element of this principle that requires the revenue system be as simple as possible to administer. Further, SME contracts increased the cost of tax administration, thus raising issues of both efficiency and effectiveness.

According to DoTAX, three to five auditors were assigned to audit the high-technology tax credits in addition to their other duties. The field auditors could request the assistance of a SME who would go out with the field auditor, especially for the technical portion of the research activities to review highly technical documents that the taxpayer would provide in relation to what he or she is claiming as research. Utilized on an on-call basis, SMEs assist with documenting the results of their review.

We reviewed four SME contracts procured by DoTAX that ranged in amount from \$14,500 to \$50,000 for various types of services. In total, DoTAX provided us with 12 SME contracts totaling more than \$220,000 for the contract period starting April 2006 and ending December 2010. We also found that Act 213 (SLH 2007) appropriated \$300,000 for FY2008 and \$300,000 for FY2009 to DoTAX to be used for contracting with specialized experts to support income, general excise, and other tax audits. DoTAX used the funds for SMEs in an effort to close audit cases relating to high-technology tax credits.

Lacking statutory directives to do otherwise, DoTAX implemented high-technology tax credits as it had all tax credits

The law was silent and did not specifically direct DoTAX's administration of the tax credits, so DoTAX implemented the high-technology business investment and research activities tax credits like any other tax credit, which according to its mission is "to administer the tax laws for the State of Hawai'i in a consistent, uniform, and fair manner." Therefore, DoTAX issued tax forms and guidance to taxpayers through tax information releases and tax announcements, audited taxpayers, and reported on the tax credits as it had all other tax credits. We conclude that DoTAX adequately planned and implemented the high-technology business investment and research activities tax credits according to its usual process.

Tax forms and guidance were issued to taxpayers

We found that DoTAX processed the tax forms for the high-technology business investment and research activities tax credits like all other tax forms, with the exception of Form N-317 electronic forms. According to DoTAX, Form N-317 *Statement by a QHTB* was a survey and did not involve tax computation; hence, this form was handled differently and approved by higher management.

To assess the department's processing of forms, we reviewed the forms log for the various tax forms relating to the high-technology business investment and research activities tax credits. According to the department's forms coordinator, the forms log serves as the department's record of forms, with all new and revised tax forms logged and circulated to the department's Forms Control Committee for review and comment. The Forms Control Committee consists of the management staff, including the director and deputy director. Tax forms are created and revised according to tax law changes by the Technical Section of the Rules Office.

We also reviewed numerous tax information releases and announcements issued by the department relating to the high-technology tax credits. The Rules Office prepares both tax information releases and announcements. Tax information releases are topic assigned and relate to matters of policy. They do not carry the same legal weight as laws and rules, but they do provide important guidance in the absence of precision in the law and when the rules are silent. Tax announcements relate to matters that do not involve policy. They are usually issued after each law is passed and include a description.

Audits targeted taxpayers, not tax credits

The Compliance Division, Field Audit Branch selects and examines taxpayer returns, including the high-technology business investment and research activities tax credits, as it normally does for compliance with state laws. The returns classifying officer's primary duty is to select

audits for field audit and review large refunds and abnormalities. He identifies the tax return; if the return includes tax credits, he may review them. He does not specifically look for returns with high-technology business investment and research activities tax credits when identifying returns to audit. He generally selects from worklists in the system generated from the tax returns processed. The worklists are run using different categories of refunds for a number of criteria and are for all tax returns with refunds, not specific to the investment and research tax credits. Some of the refunds may include taxpayers who did not claim any type of tax credit.

We reviewed Tax Information Release No. 2003-1 that indicated that DoTAX would be developing and implementing an audit program intended to target abusive claims of the high-technology business investment credit. However, we were told by the returns classifying officer and a department auditor that there is no audit program specifically for the high-technology business investment and research activities tax credits. The field auditors use the same audit program as for other audits. We could not determine if they have in place “an audit program intended to target abusive claims of the high-technology business investment credit” as required by the 2003 tax information release, because we were not allowed access to department audit programs.

High-technology tax credits were included in department’s report of all tax credits

The high-technology business investment and research activities tax credit law was also silent on additional or separate reporting. From 1999 until 2005, DoTAX included the high-technology tax credits in its legally mandated *Tax Credits Claimed Report by Hawai‘i Taxpayers*, which only releases category totals because tax laws render taxpayer information confidential.

The *Tax Credits Claimed Reports by Hawai‘i Taxpayers* are mandated by Act 250 (SLH 1996). In 1996, the Legislature found that certain reports published by the department’s Tax Research and Planning Office are an important source of information for government in its decisionmaking and for the public. Accordingly, Act 250 mandated continued paper form reporting. However, since the tax department is indefinitely suspending publication of future issues of these reports due to budget constraints, new methods of financing the costs of publication and distribution are needed. This act also requires the department to begin distribution of the reports in commonly accessible electronic forms and to charge fees for paper and electronic versions of the reports.

We reviewed the *Tax Credits Claimed Reports by Hawai'i Taxpayers* for tax years 1999 to 2005 and found that both the high-technology business investment and research activities tax credits were included in these reports with all other tax credits. However, we found that DoTAX has not issued reports for tax years 2006, 2007, 2008, and 2009 due to lack of resources. The department's inability to produce these reports will be discussed in greater detail later in this report.

DoTAX's Processing, Monitoring, and Reporting of High-Technology Tax Credits Lack Transparency and Are Inadequate and Unreliable

The law required DoTAX to implement, administer, and report on the high-technology business investment and research activities tax credits to ensure taxpayer statutory compliance and to measure its effectiveness. However, the State does not have the means to adequately evaluate and measure the tax credits' success, which could justify \$1 billion in lost tax revenues. In addition, taxpayer confidentiality prevents DoTAX from disclosing more meaningful information, which severely limited our audit and hinders transparency and public scrutiny.

In addition, the poorly written law made it impracticable for the department to fully certify qualified investments, increasing the risk of abuse as taxpayers may be receiving tax credits for which they may not qualify. Moreover, DoTAX was unable to effectively collect and report complete and reliable data. Compounded by the fact that the department stopped reporting on the high-technology tax credits in 2010, the Legislature has not been provided a true picture of the costs and benefits of the tax credits, which could mislead it in its policy decisions.

State unable to measure the tax credit impacts that would justify \$1 billion in lost tax revenues

As of tax year 2009, nearly \$1 billion in high-technology and research activities tax credits have been issued, but the State has been unable to measure their impacts. Moreover, the current cost of the tax credits is not known since the department does not plan to issue reports covering the cost of the credits for tax years 2010 and beyond. This approximately \$1 billion cost in lost tax revenue, which is not subject to legislative oversight in the budget process, escapes accountability.

According to the PEW Center on the States report, *Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth*, Hawai'i is ranked as the one of the states trailing behind in its evaluations of tax incentives. This designation was given to those states that did not review all major tax incentives and did not use data to inform policy choices. The department's reports on the tax credits met none of the criteria noted by PEW, yet the high-technology and research activities tax credits are among the most generous in the country. The center writes that an effective state evaluation on tax incentives should "inform policy choices, include all major tax incentives, measure economic impact and draw clear conclusions."

Through Act 206, SLH 2007, the Legislature tasked DoTAX with measuring the effectiveness of the tax credits. The Legislature recognized that better evaluation to measure the effectiveness of the tax credits was needed, and that accurate information on the efficacy of the credits were lacking. The department merely reported on the data that it collected but failed to say whether the credits were effective. The department's administrative rules specialist told us that the department tried to report on the credits' effectiveness, but did not do so because there were "too many variables" to consider. Ultimately, the Legislature will not get the information that it requested.

Taxpayer confidentiality renders DoTAX the only agency with access to high-technology tax credit information, thus hindering transparency

The Legislature tasked DoTAX to process, monitor, and report on taxpayers claiming the high-technology tax credits. However, taxpayer confidentiality laws prevented DoTAX from disclosing the information needed to measure their effectiveness. It also hindered our access to information during our audit. As a result, there is very little transparency over the high-technology tax credits; in fact, access to tax credit information by legislators and during our audit was severely limited. For example, during our audit, our office was restricted access to key areas within the department because of concerns that we would be put in contact with taxpayer information. Any contact, whether intentional or inadvertent, would be a violation of law. As a result, we amended our audit procedures to accommodate department restrictions. In some cases, our work was limited to interviews and review of redacted documents produced by the department. We were not allowed to pull data ourselves from department records. And at times, we were not granted access to data and were thus unable to independently validate and verify some information.

The Legislature, too, expressed frustration at not being able to obtain meaningful data from the DoTAX. For example, one legislator shared with us his concerns on how to balance taxpayer confidentiality with transparency and oversight, especially because the Legislature could not get taxpayer numbers or information on who was benefiting from the credits. He stated that it was "hard to peek in the DoTAX." Another legislator commented that the tax credit information reported by DoTAX was not clear; it was never clear what was paid out. In the end, taxpayer data for high-technology tax credits are not available for public scrutiny.

To alleviate these data challenges, the Legislature needs to consider requiring disclosure of certain taxpayer information in exchange for tax credit claims. The PEW Center on the States report, *Evidence Counts*, states that access to high-quality data is essential for determining return on investments on tax incentives, including tax credits. Lawmakers play an integral role in ensuring that data are collected and made available. One approach is to create access for evaluators to mine

existing information, which often involves using tax data that are subject to restrictive confidentiality laws. Lawmakers, however, can make exceptions. In fact, the report provided an example of one state where a general assembly authorized a research team to access confidential tax data from its department of revenue and employment data from its department of labor.

Although the Legislature mandated the reporting of more revealing data in 2007, eight years after the creation of the tax credits, the law did not go far enough and only mandated reporting of individual businesses' names and aggregated QHTB information. The Legislature still lacked the meaningful data needed to evaluate the tax credits.

Taxpayer certification and audit processes do not verify qualifying investments, heightening risk of abuse

The Rules Office is responsible for certifying the amount of tax credits for all taxpayers claiming the credit by verifying the nature and amount of the qualifying investments. However, due to a poorly designed law that provides a short window of time to process the certifications, the office only performs a high-level verification, which basically validates the numbers and “checks the math.” The office shifted the more extensive responsibility of verifying the taxpayers' information to the department's Compliance Division, Field Audit Branch, which audits taxpayer returns long after the certifications are issued. However, the division only audits a fraction of all taxpayers claiming these tax credits. This increases the risk of abuse as taxpayers may be receiving tax credits for which they may not qualify, resulting in a loss of tax revenue to the State.

Taxpayers may receive tax credits for which they do not qualify

The department does not adequately verify the accuracy or completeness of information submitted by taxpayers claiming the tax credits. Further, the DoTAX raises the risk of fraudulent and abusive practices of these tax credits by not adequately verifying taxpayer compliance with relevant statutory requirements. Given that the total amount of the tax credits claimed is almost \$1 billion, the State could do more to minimize the risks of loss of this significant tax revenue.

The department has acknowledged the potential for taxpayer abuse of the high-technology business tax credits in its Tax Information Release No. 2003-1, dated March 2003. The department acknowledges that certain taxpayers may be engaged in potentially abusive transactions involving the high-technology business investment credits. It lists some of the types of transactions that do not qualify for the credits, including investments that lack economic substance or a business purpose, and related party transactions that minimize the amount of actual investment or “new money.”

Moreover, the Tax Review Commission commented on the difficulty of enforcing tax incentives in its 2001–2003 report, wherein it stated, “audit is a very labor-intensive form of enforcement. Less than 2 percent of all taxpayers are audited. Tax incentives may effectively give money away through a tax collection system that is not particularly well equipped to enforce compliance with these laws.” The report continued:

[E]nacting business incentive tax credits without accountability is akin to asking taxpayers to fill out a blank check at public expense. . . . The commission believes that accountability is the backbone of sound tax policy, and that without it, the tax system will be open to non-compliance and abuse.

Rules Office does not verify certifications due to short window to process and relies on Compliance Division’s audits

The Rules Office is responsible for verifying the nature and amount of the qualifying investments and expenditures of taxpayers claiming the tax credits prior to issuing a certificate to the taxpayer. However, we found that the law gave the Rules Office a short window of time to process the certifications, which numbered in the thousands. As a result, the office does not verify certifications, thereby shifting this responsibility to the Compliance Division’s Field Audit Branch.

According to the law, taxpayers claiming a qualified high technology business investment tax credit must submit a written, certified statement to the director of taxation identifying qualified investments and the amount of tax credits claimed. Qualified high technology businesses claiming research and development credits were required to submit a similar statement to the director identifying qualified expenditures and the amount of tax credits claimed.

The department developed a process to fast-track certifications in the prescribed time. First, taxpayers submit tax Form N-318A for the high-technology business investment tax credit, or tax Form N-319A for the research activities tax credit. The deadline to submit the forms is March 30 of the following year for calendar year filers and before the last day of the third month following the close of the fiscal year for fiscal year filers. Second, the Rules Office processes the taxpayer’s Form N-318A or N-319A by verifying information submitted to the department, including qualifying investment amounts or qualifying costs or expenditures, respectively, the credit amount certified for each taxable year, and the cumulative amount of the tax credit during the credit period. Lastly, it issues a certificate to the taxpayer to file with the taxpayer’s tax return, which is due on April 20. In other words, the office has only 21 days to issue a certificate to the taxpayer.

The DoTAX annual report for 2009–10 stated that the Rules Office staff reviewed and certified 1,694 requests for the high-technology business investment tax credit, and 1,260 requests for the research activities tax credit. Together this totals almost 3,000 certifications to process within 21 days, amounting to upwards of 140 certifications per day.

Given the short window of time and the high volume of certifications, the office performs only a high-level verification and staff acknowledged that it basically validates the numbers and “checks the math” on the forms. According to the prior rules officer, “it is difficult to verify” that the money was invested. An administrative rules specialist stated, “the certifications are taken at the taxpayer’s word.”

The department acknowledges the difficulty in processing the certifications timely, thereby shifting the responsibility to verify the taxpayer information to its Compliance Division. Tax Forms N-318A and N-319A provide that “[a]ll claims are subject to audit” and “[t]he Department expressly reserves all rights to challenge, in whole or in part, the claim for credit.”

Moreover, our review of the Rules Office certification process found staff do not follow the department’s internal procedures. Such procedures, according to the U.S. Government Accountability Office’s (GAO) *Standards for Internal Control in the Federal Government*, are internal controls and are an integral component of an organization’s management that provides reasonable assurance on the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The Rules Office provided us with internal procedures for the review of the Forms N-318A and N-319A. However, staff responsible for processing the certifications were not aware and did not use these procedures. When we asked the administrative rules specialist, who is primarily responsible for the certifications, if there are written policies, procedures, or checklists for the tax credit certifications, he responded that the certifications follow the statute. In addition, the Rules Office secretary was unaware that there were procedures.

In addition, both the administrative rules specialist and Rules Office secretary also stated that reviews and independent verifications of their work in the certification process are not performed. In addition, the administrative rules specialist noted that there is no management involvement in this process. There is also no identified backup for the one administrative rules specialist who processes the certifications. If he is out of the office, the certifications wait until he returns. Likewise, the Rules Office secretary stated that her work is left in stacks until she returns to the office. Here, too, are examples of how a lack of control activities—such as approvals, verifications, and backups—undermine

the department's ability to achieve effective results and provide proper stewardship of government resources. Thus, the procedures (internal controls)—which are designed to meet the missions, goals, and objectives of the certifications and which serve as the first line of defense in preventing and detecting errors and fraud—failed.

To address these deficiencies, the department should strengthen and formalize in writing internal controls over its processes. Even though the certifications described here in our report have sunset, this recommendation can be applied throughout the department to improve its tax processes.

Compliance Division audits only a fraction of taxpayers claiming high-technology tax credits

A major function of the Compliance Division is to conduct field examinations and investigations of taxpayer returns, books of accounts, and pertinent records for compliance with state tax laws. In performing this function, the division seeks to ensure uniformity in the application of the State's tax laws; ensure that taxes due to the State are correctly assessed; promote responsibility and accuracy in the self-assessment of taxes; and deter evasion and carelessness in the filing of tax returns.

Although the DoTAX relies on the Compliance Division to audit, thereby verifying the nature and amount of the qualifying investments and expenditures of taxpayers claiming the high-technology tax credits, we found that the division only audits a fraction of all taxpayers claiming these tax credits. Furthermore, we were informed that audits are completed long after the certifications are issued and the division selects audits based on taxpayer tax returns, not by tax credits. Thus, DoTAX cannot ensure that all taxpayers claiming the credit are reporting correctly.

We also found that the Compliance Division audits less than 100 percent of the taxpayers who claim these credits; however, they could not provide an accurate percentage of how many they do audit. We had difficulty obtaining information on audits conducted by the division because it does not keep or report these statistics. According to the Compliance Division administrator, monthly internal reports provide assessments done and audits performed, but he is unaware of compiled statistics specific to the tax credits. The acting Collection Branch chief stated that they would need to manually track each audit to develop statistical information on the tax credits. She also stated that she was not aware if any statistical reports were maintained, and a now-retired field audit manager may have known of ad hoc reports. The Compliance Division administrator prepared statistics on the number of high-technology tax credits audited for the period July 1, 2011 through December 31, 2011

by asking the group chiefs and branch chiefs to compile data for their respective areas. However, we were unable to verify the data because we were not allowed access to department records.

We also searched and found two reports that provided statistics on the audits performed on the tax credits: 1) *DoTAX Annual Report as Required by Act 213, SLH 2007, Section 119* (DoTAX, 2008); and 2) *Report of the 2005–2007 Tax Review Commission, Appendix B—Measuring the Costs and Benefits of Hawai‘i’s QHTB Investment Tax Credit*. In the *DoTAX Annual Report*, DoTAX reported that 64 audits relating to high-technology tax credits were initiated, of which 45 cases were closed and \$26.3 million in credits denied for the period July 2007 through November 2008. The Tax Review Commission’s *Appendix B* report provided statistics on the total number of credit claims, number of actual audits, number of new cases selected for audit by year, and percentage selected for audit for the years 2001–04. When asked, the department was unable to provide documentation to support the data from both reports. The acting Collection Branch chief stated that the reports must be ad hoc because the department does not regularly prepare these types of reports.

Unable to verify the department’s data, we compiled the information ourselves. Utilizing existing data from various reports, we found that for tax years 2001–04, an average of less than 3 percent of the total number of high-technology tax claims were selected for audit. We note that for tax years 2005 through 2008, a lack of data precluded our analysis. Exhibit 2.10 displays the number of audits performed, by fiscal year, and the number of high-technology tax credit claims, by tax year. Exhibit 2.11 displays the number of new high-technology tax claims selected for audit, by year, in relation to the number of high-technology tax credit claims, by tax year. We compared these numbers because no other data was available.

In addition to auditing only a fraction of the tax credits, the department conducts audits long after the certifications are issued. According to the department’s audit group chief, in general, the average length of time from when an audit is requested to when it is completed can be two to four years, depending on several factors: the complexity of the tax return; if it involves related entities; and if the taxpayer asks for an extension of time. The group chief informed us that an audit is deemed complete when the taxpayer is informed of the audit findings, the audit has been reviewed, and the branch chief is ready to issue the proposed adjustment to the taxpayer.

Exhibit 2.10

Number of Audits Performed Compared With Number of High-Technology Tax Credit Claims for Tax Years 2001 Through 2008

Tax Year	Total # of Claims (by tax year)			# of field audits completed (by fiscal year)	% of field audits completed to total # of claims (column d / c)	New tax credit cases selected for audit (by year)	% of new tax credit cases selected for audit to total # of claims (column f / c)	% of new tax credit cases selected for audit to # of field audits completed (column f / d)
	Investment Tax Credit	Research Tax Credit	Total Investment & Research tax credit claims (column a + b)					
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
2001	268	118	386	384	99.48%	5	1.30%	1.30%
2002	493	153	646	279	43.19%	10	1.55%	3.58%
2003	652	165	817	254	31.09%	16	1.96%	6.30%
2004	1,040	245	1,285	242	18.83%	15	1.17%	6.20%
2005	1,216	224	1,440	243	16.88%	no data	n/a	n/a
2006	1,842	401	2,243	291	12.97%	no data	n/a	n/a
2007	2,235	no data	2,235	318	14.23%	no data	n/a	n/a
2008	2,488	no data	2,488	320	12.86%	no data	n/a	n/a
Total	10,234	1,306	11,540	2,331				

Source: Office of the Auditor

Exhibit 2.11

Number of New High-Technology Tax Credits Selected for Audit (by year) Compared With Number of High-Technology Tax Credit Claims (by tax year), 2001 Through 2004



Source: Office of the Auditor

The Compliance Division continues to audit based on taxpayer tax returns, and does not target tax credits. When we asked the division officials if they were aware that the Rules Office relies on the division to determine whether the taxpayer is reporting the tax credit claims correctly, the group chief responded that she was unsure how the Rules Office certifies, but is aware that the certification forms mention that certifications are subject to audit. The returns classifying officer is aware of the office's reliance, but continues to identify and select audits as he normally does, by first identifying the taxpayer tax return, not the tax credit.

Our review of the Compliance Division's audit identification and selection process found that DoTAX has not implemented adequate controls over management reviews, written policies and procedures, independent verifications, and training. Similar to our findings related to the department's certification process, these are internal control weaknesses that undermine rather than support the department's effectiveness and efficiency of operations and compliance with applicable laws and regulations. For example, a written audit manual serves as the department's guide for the Compliance Division in conducting audits. However, the returns classifying officer stated that he does not use the manual and does not have any written policies and procedures; rather, "it is all in [my] head."

In addition, the returns classifying officer stated that verifications and reviews are not performed on his audit selection process, and he has not received any formal training on the tax credits. When we asked about training received, the returns classifying officer responded, "it's judgmental." Lack of supervision by the Compliance Division administrator represents another internal control weakness that may undermine the department's operations.

According to the GAO, control activities such as policies, procedures, approvals, and verifications are an integral part of accountability for stewardship of government resources and achieving effective results. Control activities should be effective and efficient in accomplishing the agency's control objectives. We reiterate that the department should strengthen its internal controls to support its efficient and effective operations.

Inadequate, unreliable, and late-reporting of tax credit information may mislead policymakers in their decisionmaking

In order to make sound decisions when allocating state resources, policymakers need tax expenditure reports describing tax breaks, their cost, and other relevant information for evaluation. The Center on Budget and Policy Priorities, a national policy organization working at the state and federal levels on fiscal policy, recommends that the reports be readily available and contain current information. The reports must

also be published regularly, every one to two years since information that is several years old are of limited use. We found that the DoTAX reporting of tax credits does not meet these criteria, does not provide accountability and transparency as to the true cost of these credits, and may mislead policymakers in their decisionmaking. Further, the data are unreliable and do not capture all of the QHTB activities; and the department's *Tax Credits Claimed by Hawai'i Taxpayers* reports are late and have not been published for tax years 2006, 2007, 2008, and 2009.

Policymakers need good evidence to make informed policy choices

Policymakers, the media, and the general public need information about tax expenditures to fully participate in decisions about how to allocate state resources. In a report entitled *Promoting State Budget Accountability Through Tax Expenditure Reporting*, The Center on Budget and Policy Priorities writes that this can be addressed by regularly publishing a tax expenditure report which lists the state's tax breaks and how much each one costs, along with other relevant information that helps policymakers and others evaluate them. By helping policymakers understand the purpose of each tax expenditure and whether it is achieving its purpose, these evaluations can promote meaningful debate about retaining, modifying, or eliminating the tax expenditure.

Unreliable data render statement of qualified high technology businesses meaningless

Contrary to the Legislature's need for good evidence on tax credits, we found that the data contained in DoTAX reports on the high-technology business investment and research activities tax credits are unreliable and result in inadequate reports on QHTB activities. One of the reasons the data do not provide a true picture of the costs and benefits of the tax credits is that only some of the QHTBs file the Form N-317 survey, which is used to compile the reports. The department relies on these reports, which are mainly comprised of self-reported data, does not verify the data, and has not enforced the penalties established for failure to file this survey form. The department also did not publish a report for tax year 2010, the final year that the credits were available, and does not plan to do so even though it has the raw data. Further, DoTAX refused our access to aggregated data so we were unable to test the validity of the data contained in the reports. Ultimately, we conclude that DoTAX reports of QHTBs are meaningless.

The department admits that not all QHTBs file the Form N-317, which is used to compile the reports that are required by law. This results in a report that only contains information of those QHTBs that have reported on their activities, but is not representative of all of the QHTBs that

claimed the credit. Without complete information on all QHTBs, the department's reports cannot fulfill the mandates of Act 206 (SLH 2007), which sought to measure the effectiveness of high-technology business investment tax credits. According to the law, QHTBs receiving an investment for which a credit may be claimed were required to submit an annual survey Form N-317. The department was then tasked with using the information provided by the QHTBs to provide reports to the Legislature regarding the tax credits. Since every QHTB that claimed a tax credit has not filed the Form N-317, we will never know the full range of QHTB activities. For example, we reviewed the department's 2008 report, *Descriptive Statistics on the Operations of Qualified High Technology Businesses from 2002 through 2007*, and noted that DoTAX disclosed that as many as one-third of QHTBs required to file the Form N-317 failed to do so by the filing deadline of June 30, 2008. The following year in the 2009 report, *Descriptive Statistics on the Operations of Qualified High Technology Businesses from 2002 through 2008*, we found that DoTAX noted that only 50 percent of QHTBs filed the Form N-317.

Further, the reports rely on QHTB self-reported data. Data consistency cannot be assured as the QHTBs may have interpreted and therefore reported on the survey questions in different ways. If so, the differing interpretations of the survey questions by QHTBs may result in an inaccurate report on the required data categories. Our review of the DoTAX's 2007 *Report on the Operations of Qualified High Technology Businesses from 2002 through 2006* found that DoTAX was aware that respondents interpreted the term "jobs" in different ways—some measured jobs as full-time equivalent jobs, while others did not; and some included jobs created outside their own operations, such as in companies that provided services to QHTBs. While DoTAX pointed out the discrepancies, we note that it made no attempt to rectify them.

The department has not enforced penalties established in Act 206 for failure to file the Form N-317. When asked, department officials told us that penalties were not assessed because the DoTAX did not have the resources to program its Integrated Tax Information Management System (ITIMS) to produce bills assessing the penalties. Because DoTAX did not enforce these penalties, QHTBs were allowed to file the Form N-317s on an irregular basis, thus impacting the amount of data that were available to report on QHTB activities. As a result, DoTAX issued reports that it said was an inaccurate representation of taxpayer activities. Again, we note that DoTAX recognized the deficiencies, but did nothing to fix them.

Additionally, DoTAX did not report on the high-technology business investment and research activities tax credits for tax year 2010—the final year that the credits were available—and thus did not fulfill the Act

206 reporting requirement. The 2010 report entitled, *The Impact of the High Technology Business Investment Tax Credit on Hawai‘i’s Economy for Calendar Year 2009*, was the last report that DoTAX released regarding the tax credits. When asked, department officials told us they discontinued reporting on tax credits into the 2010 tax year because the department’s Rules Office determined that the high technology tax credit law and its tax credits sunset in 2010, so the Act 206 reporting was no longer required. We disagree with this interpretation and assert that the Act 206 reporting requirement for DoTAX did not end. For every year after 2007, Act 206 required DoTAX to compile two reports per year regarding both tax credits. The purpose of Act 206 was to “. . .measure the effectiveness of. . . [the] high technology business investment tax credit. . .” It is illogical to suspend reporting before the final year of the tax credits—tax year 2010. To fulfill the Act’s purpose, the department should at least report through tax year 2010. A better practice would be to extend reporting through tax year 2014 since taxpayers may claim credits in the first year (for example, tax year 2010) and in the subsequent four years (thus, tax years 2011, 2012, 2013, and 2014).

Finally, we were unable to test the validity of the department’s data and are therefore unable to determine its reliability. As part of our audit work, we planned to test the data and requested supporting documentation for data tables that appear in various reports while assuring the department we did not want confidential taxpayer information. Even with our assurances, the department denied our access and we were unable to conduct our testwork. Although Section 235-116, HRS, provides that all tax returns and return information are confidential, and revealing such information is a violation of the law, our inability to gain access to data totals suggests that the department can use its confidentiality provisions to frustrate review of its work. In effect, the provisions undermine transparency by effectively rendering the department unauditible. To date, we have yet to receive a response to our request for data totals.

Tax Credits Claimed reports for tax years 2006, 2007, 2008, and 2009 stalled by inadequate staffing

We found the most recent *Tax Credits Claimed by Hawai‘i Taxpayers* report was published in 2007 for tax year 2005. The department has not published reports for tax years 2006, 2007, 2008, and 2009. The tax credit reporting is very late, and the most recent data available is now six years old. Reports for tax year 2006 and beyond have not been issued because DoTAX claims it does not have enough staff to compile and review the reports. We obtained and reviewed budget justification tables for years 2007 through 2009, which showed that in those years, the department had staff resources that were tasked with compiling the reports. However, the administrative services officer later confirmed

that the positions were abolished in 2009 and that the department's 2012 request to restore two of the positions had been denied.

The publication of this general report on tax credits has been mandated since 1996 by Section 231-3.4, HRS. At that time, DoTAX reporting had stopped. The Legislature, sensing that it did not have the information it needed on tax expenditures for its appropriation decisionmaking, mandated that DoTAX report on several general topics. This report provides information on the tax credits claimed and assesses the impact of changes in the law on the tax credits. In the report, DoTAX provides a short analysis of *every* tax credit for the given tax year and reviews the credits claimed by individuals, nonfinancial corporations, financial corporations, insurance underwriters, and fiduciaries.

To ensure the Legislature receives good information on its tax expenditures, including its tax credits, the department should publish its *Tax Credits Claimed by Hawai'i Taxpayers* reports for tax years 2006 through 2009. Since the reporting is required by law, the department must fulfill the requirement, regardless of the lack of staff to do so. The Legislature is encouraged to support the department's efforts to restore the staff positions needed to carry out the work.

Conclusion

When the Legislature decided in 1999 to support the growth and development of high-technology industries in Hawai'i by way of high-technology tax credits, it gave up its appropriation power and oversight over what would become significant tax expenditures. To date, the department estimates that high-technology tax credits have cost the State almost \$1 billion in lost tax revenue. Lacking the information needed to measure their effectiveness, however, the State will never know the extent of their success.

Although the credits have sunset, there may be similar opportunities on the horizon that the Legislature may wish to support by way of state policy. At that time, the Legislature should consider embedding a means to measure effectiveness, including specific goals, performance standards, and an evaluation process. It should articulate its expectations for executive branch agencies—in this case, the DoTAX—so there is agreement on implementation of the law, and ultimately processing, monitoring, and reporting on the initiative. Without this understanding and the appropriate infrastructure in place to support the initiative, the State will never know the success of its policies.

Recommendations

Even though the high-technology tax credits have sunset, our first recommendation can be applied to all economic development incentives.

1. When developing legislation for high-technology business investment and research activities tax credits, the Legislature should consider:
 - a. Including the following elements as suggested by best practices for economic development incentive policy:
 - i. Goals and objectives;
 - ii. Evaluation process; to design a regular, rigorous, and comprehensive evaluation process for tax incentives, consider the following:
 1. Inform policy choices—build evaluation of incentives into policy and budget deliberations to ensure lawmakers use the results.
 2. Include all major tax incentives—establish a strategic and ongoing schedule to review all tax incentives for economic development.
 3. Measure economic impact—ask and answer the right questions using good data and analysis.
 4. Draw clear conclusions—determine whether tax incentives are achieving the state’s goals.
 - iii. Performance standards; and
 - iv. Monitoring and compliance
 - b. Whether DoTAX is the appropriate agency to administer high-technology business investment and research activity tax credits; and
 - c. Whether taxpayer confidentiality requirements should be removed for taxpayers claiming the credits to enhance transparency and enable measurement of effectiveness.

2. The Department of Taxation should:
 - a. At a minimum, report on the 2010 tax year Form N-317, *Statement by a Qualified High Technology Business (QHTB)*, data. Further, reporting should continue for the subsequent four years to capture the high-technology business investment tax credit's maximum allowable credit up to \$2 million.
 - b. Report on the tax credits claimed in tax years 2006, 2007, 2008, and 2009 as mandated by law.
 - c. Strengthen and formalize in writing internal controls over department processes, including audit identification and selection, to provide reasonable assurance that the following objectives are being achieved:
 - i. Effectiveness and efficiency of operations;
 - ii. Reliability of financial reporting; and
 - iii. Compliance with applicable laws and regulations.
 - d. Design a regular, rigorous, and comprehensive evaluation process for tax incentives. Consider the following criteria when designing the process:
 - i. Inform policy choices—build evaluation of incentives into policy and budget deliberations to ensure lawmakers use the results;
 - ii. Include all major tax incentives—establish a strategic and ongoing schedule to review all tax incentives for economic development;
 - iii. Measure economic impact—ask and answer the right questions using good data and analysis; and
 - iv. Draw clear conclusions—determine whether tax incentives are achieving the state's goals.

Response of the Affected Agency

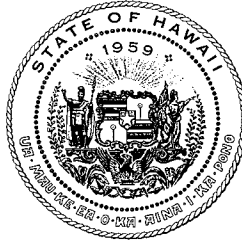
Comments on Agency Response

We transmitted a draft of this report on July 6, 2012 to the Department of Taxation. A copy of the transmittal letter to the department is included as Attachment 1. The department's response, submitted on July 16, 2012, is included in its entirety as Attachment 2.

In its response, the department expressed its appreciation for our report. The department concurs with our findings that the continuous legislative changes since 1999 increased the complexity of the tax credit provision and the department's responsibilities. To address our recommendations, the department is in the process of recruiting to fill vacant and other positions needed to complete reporting on the tax credits for prior years. Lastly, the director assured us that the department will continue to review our recommendations for improvements.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

July 6, 2012

COPY

The Honorable Frederick D. Pablo
Director
Department of Taxation
830 Punchbowl Street, Room 221
Honolulu, Hawaii 96813

Dear Mr. Pablo:

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits*. We ask that you telephone us by Tuesday, July 10, 2012, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Monday, July 16, 2012.

The Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this confidential draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

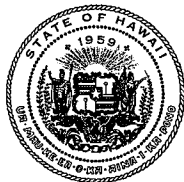
A handwritten signature in cursive script, appearing to read 'Marion M. Higa'.

Marion M. Higa
State Auditor

Enclosures

NEIL ABERCROMBIE
GOVERNOR

BRIAN SCHATZ
LT. GOVERNOR



FREDERICK D. PABLO
DIRECTOR OF TAXATION

RANDOLF L. M. BALDEMOR
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION

P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO.: (808) 587-1540
FAX NO.: (808) 587-1560

July 16, 2012

RECEIVED

2012 JUL 17 AM 8:45

OFF. OF THE AUDITOR
STATE OF HAWAII

Ms. Marion Higa, State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Ms. Higa:

Thank you for the opportunity to comment on the draft report titled "Audit of the Department of Taxation's Administrative Oversight of High Technology Business Investment and Research Activities Tax Credits". The high-technology tax credits were created in Act 178, Session Laws of Hawaii 1999 (SLH) effective January 1, 2000 and repealed in Act 206 (SLH2007) effective December 31, 2010. During this ten year period, there were three tax directors who would have in-depth knowledge of how the department administered the high tech credit provisions.

I assumed the role of Tax Director in December 2010 and can provide comments on the prior years based on information gathered from the staff. We concur with your finding that the continuous legislative changes since 1999 increased the complexity of the tax credit provisions but did not increase the resources needed to match the increased responsibilities of DoTax. We also agree that while the volume of credits increased each year, the available staff hours to fulfill these duties decreased as a result of a reduction-in-force, positions were frozen when they became vacant and two consecutive years of furloughs.

Without sufficient personnel, it is difficult to meet the increase administrative and compliance requirements. In the past fiscal year, we began recruiting to fill the vacant positions. We have also requested additional funding for statistician positions which are needed to complete the reports that you recommend; currently none of our statistician positions are filled. More importantly, last year we commenced a tax systems modernization process that focuses on identifying information technology improvements and resources that our Department needs to fulfill its administrative and compliance functions.

The Department appreciates the Legislative Auditor's review of the department's procedures for administering tax credits during the past decade and will continue to review the recommendations for improvements.

Sincerely,

FREDERICK D. PABLO
Director of Taxation