Credits Continue to Tax the State: Follow-Up on Recommendations Made in Report No. 12-05, *Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits*

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The cumulative cost of high-tech tax credits may be as high as $2 billion.

Status of Recommendations

Open
1

Open and not likely to be pursued
2

Not applicable
1

Did not assess
1

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DoTAX auditors, spending all their time addressing complaints and inquiries about various high-dollar tax credit refunds, are not performing a core function—auditing tax returns

In our follow-up of recommendations made in Report No. 12-05, *Audit of the Department of Taxation's Administrative Oversight of High-Technology Business Investment and Research Activities Tax Credits*, we found that the Department of Taxation (DoTAX) continues to struggle with administrative responsibilities created by a flawed high-technology tax credit law. In Report No. 12-05, released in July 2012, we reported that DoTAX performed only a high-level review of tax credit applications, not verifying self-reported numbers. Our 2015 follow-up found that oversight responsibilities of the high-technology tax credit, along with other high-dollar and high-volume tax credits, such as the renewable energy tax credit, are overshadowing DoTAX's core oversight functions. According to DoTAX's tax compliance administrator, department auditors now spend their time responding to taxpayer complaints and inquiries about refunds for high-dollar, high-volume tax credits, such as the high-technology business investment tax credit and renewable energy technologies tax credit. As a result, DoTAX staff are neither auditing tax credit applications nor tax filings as a whole. The compliance administrator told us that DoTAX's 20 auditors currently have a backlog of hundreds of tax returns targeted for audit; however, the department lacks the resources to carry them out.

In addition, in 2012, we reported that the State had issued and was responsible for reimbursing nearly $1 billion in tax credits; however, approximately three years later, we found that this obligation has nearly doubled, to almost $2 billion. Although the State stopped issuing them in 2010, high-technology tax credits do not have a sunset date; therefore, tax credit recipients can carry over unused credits indefinitely. These obligations impact taxpayers and government services statewide.

Background on Report No. 12-05 and High-Technology Business Investment and Research Activities Tax Credits

In 1999, the Legislature passed Act 178, which encouraged Hawai'i taxpayers to invest in high-technology companies by granting a credit against taxes owed to the State. Part of a broad effort by the State to stimulate the growth and development of high-technology industries in Hawai'i, Act 178 contained eight initiatives; however, the tax credit became the hallmark of the 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 a 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—thus quadrupling the allowable amount per investment. The law did not limit cumulative tax credits available to taxpayers, so the corresponding expense to the State was unlimited. In addition, the research activities tax credit was a refundable credit and equal to 20 percent of all QHTB qualified research expenditures.

In Report No. 12-05, we found that the tax credits law and its subsequent amendments, which sunset in 2010, did not contain any goals or performance measures to effectively measure the tax credits. In addition, other states with similar tax credits administer them outside their taxation departments and their reporting requirements mandate disclosure of taxpayer information by law. Moreover, the numerous amendments to Hawai'i's law increased the number of tax credits claimed and gave DoTAX more administrative responsibilities related to the credits. Since state law was silent as to DoTAX's responsibilities, the department implemented the high-technology tax credits as it had for all credits—by issuing forms and guidance, auditing taxpayer returns, and reporting on the credits in its existing reports. In Report No. 12-05, we found that because of a high volume of applications and short window of time in which to certify them, DoTAX performed only a cursory review of credits claimed and did not verify self-reported numbers; it basically just "check[ed] the math" on applications, auditing only 3 percent of returns claiming the tax credits.

Tax expenditures are tax credits, deductions, and exemptions that reduce state revenue and cost state treasuries money in much the same way as direct spending.

At the time of our 2012 audit, the high-technology business investment and research activities tax credits had cost the State almost $1 billion, yet the State could neither measure nor assess their effectiveness. No one knew whether the tax credits were successful in meeting their purpose.

Tax expenditures: spending by another name

According to *Promoting State Budget Accountability Through Tax Expenditure Reporting*, a May 2011 study by the Center on Budget and Policy Priorities, states spend tens, maybe hundreds, of billions of dollars through tax expenditures. *Tax expenditures* are tax credits, deductions, and exemptions that reduce state revenue and cost state treasuries money in much the same way as direct spending. Providing tax preferences for some taxpayers means either imposing higher taxes on other taxpayers or foregoing public services such as better public schools or access to health care.

The *Accountability* report, which assessed states' tax expenditure reporting, found such expenditures are often much less transparent, and subject to much less scrutiny, than direct expenditures. As a result, the cost of tax expenditures can grow out of control; and because these costs are not shown in a state's budget, increases in tax expenditures can happen without a legislature's knowledge.

Many tax credit recipients, few limits

Our 2012 report found that at least 25 states offered investment tax credits that were roughly comparable to Hawai'i's high-technology business investment tax credits, although Hawai'i's 100 percent credit was well above any other state's. Maine had a 60 percent tax credit rate. New Jersey had the lowest, at 10 percent.

As of 2012, Hawai'i's had the highest annual tax credit cap, at $2 million per business. Indiana, Illinois, and New Jersey followed, at $500,000. Colorado was the lowest, at $20,000. Individual annual caps for other states generally ranged between $50,000 and $250,000. In Arkansas, the credit could not exceed 50 percent of an individual's tax liability. Wisconsin had no individual annual tax credit cap and a $20 million statewide total annual credit cap. Hawai'i did, and still does not, have a statewide total tax credit cap on the amount or value of 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 had an annual, statewide, or program total tax credit cap. Exhibit 1 shows a range of investment tax credits for selected states as of 2012.

Hawai'i's first tax credit was established in 1957 to avoid double taxation of income. Since then, numerous tax credits have been enacted, most of them designed to promote social welfare or to encourage certain industries or economic activities. According to DoTAX, the total number of tax credits reached a peak in 2008, when 21 tax credits were active.

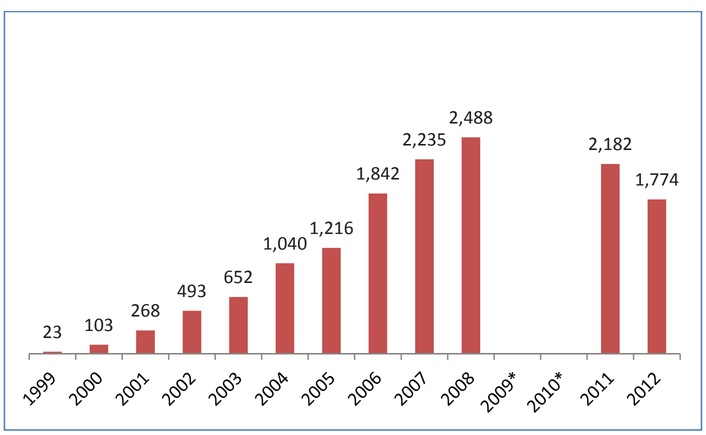
DoTAX's December 2010 publication, *The Impact of the High Technology Business Investment Tax Credit on Hawai'i's Economy for Calendar Year 2009*, reported there were 103 claims for the high-technology business investment tax credit in tax year 2000, which more than doubled in tax year 2001 (268 claims) and almost doubled again in tax year 2002. Claims continued to increase in tax years 2003, 2004, 2005, and onward through 2008.

Exhibit 1
2012 Comparison of Selected States' Investment Tax Credits

State	Name of Tax Credit (TC)	Credit Rate	Individual Cap	Total Statewide or Program Cap (M=Millions)
Arkansas	Capital Development Co. Income TC	**33.3%**	Credit cannot exceed 50% of tax liability	$5M/year from CYs 2003–2021, additional $1.25M with director's approval
Colorado	Innovation Investment TC	**15%**	$20,000/year	$750,000 in 2010
Hawai'i	High-Tech Investment TC	**100%, 80% effective 5/1/2009**	$2M/business	None
Illinois	Angel Investment Credit	**25%**	$2M/investment (or $500,000/business calculated at 25% of $2M)	$10M/CY
Indiana	Venture Capital Investment TC	**20%**	$500,000/year/business	$12.5M/year
New Jersey	High-Tech Investment TC	**10%**	$500,000/year/investment or 50% of total tax liability	None
New Mexico	Angel Investment Credit	**25%**	$25,000/year investment up to two investments/year	$750,000/CY
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
Rhode Island	Innovation TC	**50%**	$100,000/total/carried forward 3 years	None
Wisconsin	Angel Investment TC	**25%**	None	$6.5M in CY2010, $20M/CY thereafter

Source: Office of the Auditor

Exhibit 2
Number of High-Technology Business Investment Tax Credit Claims, Tax Years 1999–2012



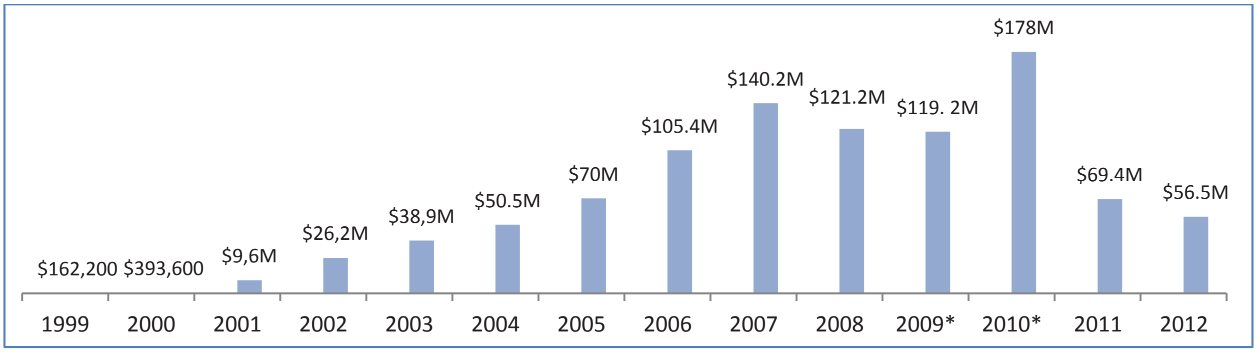
*DoTAX did not report on tax credits for tax years 2009 and 2010.

Source: Department of Taxation

Exhibit 2 shows high-technology business investment tax credit claims for tax years 1999 through 2012.

According to the DoTAX 2010 report, the cumulative cost of high-technology investment tax credits from 1999 through 2010 was $857.6 million. However, from 2000 to 2009, qualified high-technology businesses made $1.7 billion in cash investments. Because the high-technology tax credit is for 100 percent of taxpayers' investments, $1.7 billion represents both the total cash investments and tax credits earned by the taxpayers from 2000 to 2009. Therefore, nearly $1 billion more in DoTAX-approved tax credits had not been claimed at the time of the 2010 report's publication. The State remains obligated to honor these tax credit claims.

Exhibit 3
Dollar Value of High-Technology Business Investment Tax Credit Claims, Tax Years 1999–2012



*DoTAX temporarily suspended tax credit studies in 2009 and did not formally report on tax years 2009 and 2010. Claims for tax years 2009 and 2010 tax credit claim numbers are DoTAX estimates.

Source: Department of Taxation

Exhibit 3 shows the dollar value of high-technology business investment tax credit claims for tax years 1999–2012. Exhibit 4 shows cash investments received by qualified high-technology businesses in Hawai‘i from 2000 to 2009.

Exhibit 4
Cash Investment Received by 419 Qualified High-Technology Businesses in Hawai‘i, 2000–2009

Activity	Cash Investment 2000–2009
Research as in IRC Sec. 41 (d)	$124,555,928
Biotechnology	$79,838,645
Computer Software	$236,347,023
Non-fossil Fuel Energy	$137,329,612
Performing Arts	$659,946,370
Ocean Sciences	$26,215,752
Multiple Activities & Others	$440,613,054
TOTAL	$1,704,846,384

Source: Office of the Auditor

For investments made before May 1, 2009, any excess unused credit may be carried forward to future years until it is used in its entirety. Hawai‘i is the only state that allows an indefinite carryover period.

Tax credits are taxing department operations

According to a DoTAX report, *Tax Credits Claimed by Hawai‘i Taxpayers, Tax Year 2012*, the largest tax credit by dollar value was the renewable energy technologies tax credit, which, along with carryovers of the energy conservation tax credit, amounted to $179 million, or 48 percent of the total tax credits claimed in tax year 2012. The second largest tax credit was the high-technology business investment tax credit, which amounted to $56 million, or 15 percent of the total. Exhibit 5 shows the distribution of tax credits in tax year 2012.

Spending their time responding to inquiries and complaints about these tax credits, DoTAX staff are unable to perform a core function—auditing tax returns.

Status of Report No. 12-05 Recommendations

The 2008 Legislature amended the Auditor’s governing statute to require follow-up reporting on recommendations made in various audit reports to ensure agency accountability over audit recommendations. The purpose of this change was to apprise the Legislature of recommendations not implemented by audited agencies, and to require agencies to submit a written report within 30 days explaining why any recommendation was not implemented and the estimated date of its implementation. The Auditor must report annually, for each unimplemented recommendation: 1) the agency that was audited; 2) the title and number of the report that contained the recommendation; 3) a brief description of the recommendation; 4) the date the report was issued; and 5) the most recent explanation provided by the agency regarding the status of the recommendation.

Exhibit 5
Distribution of Tax Credits, Tax Year 2012

Tax Credits	Amount (in $1,000)	% of Total
Active Tax Credits		
Tax Credits to Promote Social Welfare		
Refundable Food Excise Tax Credit	$27,963	7.56%
Low-Income Household Renters	4,251	1.15%
Child and Dependent Care Expenses	9,288	2.51%
Child Passenger Restraint Systems	86	0.02%
Employment of Vocational Rehabilitation Referrals	17	0.00%
Low-Income Housing	11,367	3.07%
School Repair and Maintenance	d	d
Lifeline Telephone Service	59	0.02%
Tax Credits to Encourage Certain Industries or Economic Activities		
Fuel Tax Credit for Commercial Fishers	160	0.04%
Motion Picture, Digital Media and Film Production Income	12,734	3.44%
Renewable Energy Technologies	179,018	48.41%
Enterprise Zone	1,224	0.33%
Ethanol Facility	36	0.01%
Important Agricultural Lands		
Tax Credits to Avoid Double Taxation or Pyramiding of Taxes		
Capital Goods Excise	29,584	8.00%
Income Tax Paid to Another State or to a Foreign Country	37,215	10.06%
Expired Tax Credits		
Tax Credits to Promote Social Welfare		
Individual Development Account Contribution Tax Credit	d	d
Tax Credits to Encourage Certain Industries or Economic Activities		
High Technology Business Investment	56,521	15.28%
Energy Conservation Tax Credit		
Hotel Construction and Remodeling	147	0.04%
Technology Infrastructure Renovation	11	00.0%
Residential Construction and Remodeling	119	0.03%
Total, All Tax Credits	**$369,811**	**100%**

Note: “d” denotes data that was suppressed to avoid potential disclosure of confidential taxpayer information.

Source: Department of Taxation

Of our five recommendations in Report No. 12-05, we deemed two **open and not likely to be pursued**, one **open**, and one **not applicable**. We **did not assess** one recommendation, which was made to the Legislature. The following details each recommendation, its status, and actions taken related to the recommendation.

Recommendation 1 suggested best practices be applied to future legislation for high-technology business investment and research activities tax credits and was directed to the Legislature. Therefore, we **did not assess** Recommendation 1.

Recommendation 2 specified that, at a minimum, DoTAX should report on data included in the the 2010 tax year Form N-317, Statement by a Qualified High Technology Business (QHTB). Reporting should continue for four years to capture the high-technology business investment tax credit's maximum allowable credit up to $2 million.

In our 2012 audit, we found that 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 reporting requirement in Act 206, SLH 2007. The department's 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. During our 2012 audit, DoTAX 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 had sunset in 2010, so the Act 206 reporting was no longer required.

We researched the legislative history of Act 206 and its precursor, House Bill 1631, House Draft 2, Senate Draft 2, Conference Draft 1 (2007 Regular Session), and found that the Legislature established a January 1, 2011, repeal date for the law. The Legislature encouraged reevaluating the usefulness of the information collected and its analyses; however, it did not indicate who would be responsible for this. Since the reporting requirement is embedded in Act 206, which was repealed on January 1, 2011, we concur with the department's position and deem Recommendation 2 **Not applicable**.

Recommendation 3 directed DoTAX to report on tax credits claimed in tax years 2006, 2007, 2008, and 2009 as mandated by law. In Report No. 12-05, we found the most recent *Tax Credits Claimed by Hawai'i Taxpayers* report was published in 2007, for tax year 2005. The department had not published reports for tax years 2006, 2007, 2008, or 2009. The department claimed it had not done so because it did not have enough staff to compile and review the reports. DoTAX attributed this to the 2009 abolishment of staff positions that were tasked with compiling these reports.

Our follow-up review found that the department resumed publication of the formal studies in 2013 and has now issued reports on tax credits for tax years 2011 and 2012. DoTAX still lacks the staff resources to perform formal studies for the missing tax years. However, in lieu of the formal studies, the department has tabulated data on tax credits claimed in tax years 2006 through 2010 and provided this information to the Legislature. Therefore, we deem Recommendation 3 **Open and not likely to be pursued**.

Although DoTAX agrees that tax incentives should be scrutinized, it believes the task of measuring the effectiveness of tax incentives should be undertaken by economists at the Department of Business, Economic Development and Tourism.

Recommendation 4 was to 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: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

In 2012, we found that DoTAX had not implemented adequate controls over management reviews, written policies and procedures, independent verifications, or training. Similar to our findings related to the department's certification process, these were internal control weaknesses that undermined DoTAX's effectiveness and efficiency of operations and compliance with applicable laws and regulations.

In our follow-up review, DoTAX told us its Tax System Modernization project, which is scheduled to commence in summer 2015, will incorporate internal control processes including audit identification and selection, and require extensive work-flow documentation of these functions. Therefore, we deem Recommendation 4 **Open**.

Recommendation 5 directed DoTAX to design a regular, rigorous, and comprehensive evaluation process for tax incentives, and to draw clear conclusions regarding whether tax incentives are achieving the State's goals.

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. The Legislature had not been provided a true picture of the costs and benefits of the tax credits, which could mislead it in its policy decisions.

Our follow-up review found that although DoTAX agrees that tax incentives should be scrutinized, it believes the task would be more efficiently undertaken by economists in the Department of Business, Economic Development and Tourism. DoTAX told us that its Tax Research and Planning Office lost its research statistician positions in the State's 2009 reduction-in-force and has not been able to continue issuing formal reports on tax credits and tax statistics of Hawai'i's individuals and businesses. Therefore, we deem Recommendation 5 **Open and not likely to be pursued**.