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“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.

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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.