Review of Income and Financial Institutions Tax Provisions Pursuant to Section 23-93, Hawai‘i Revised Statutes

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

Report No. 22-07
June 2022

OFFICE OF THE AUDITOR
STATE OF HAWAI‘I

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STATE OF HAWAIʻI

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Foreword

This report assesses tax credits and exclusions as well as one deduction from taxation under Hawai‘i’s Income Tax and Financial Institutions Tax. Section 23-91 et seq., Hawai‘i Revised Statutes, requires the Auditor to review tax provisions on a five-year recurring cycle.

We express our appreciation to the Department of Taxation; Legislative Reference Bureau; Department of Business, Economic Development and Tourism; and the Department of Commerce and Consumer Affairs for their assistance in providing data and other information for this report.

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State Auditor

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Review of Income and Financial Institutions Tax Provisions Pursuant to Section 23-93, Hawai‘i Revised Statutes

Introduction

THIS REPORT assesses tax credits and exclusions as well as one deduction from taxation under Hawai‘i's Income Tax and Financial Institutions Tax. Section 23-91 et seq., Hawai‘i Revised Statutes (HRS), requires the Auditor to review tax provisions on a five-year recurring cycle. A complete list of tax provisions to be reviewed is included in Appendix A.

In 2019, we also began annually reviewing exemptions, exclusions, and credits provided under the General Excise Tax (GET), Use Tax, Public Service Company Tax, and Insurance Premium Tax on a 10-year recurring cycle established under section 23-71 et seq., HRS.

Tax credits are amounts subtracted directly from a filer's tax liability, thereby reducing the amount of taxes due on a dollar-for-dollar basis.

About This Report

Tax credits are amounts subtracted directly from a taxpayer's tax liability, reducing the amount of taxes due on a dollar-for-dollar basis. Deductions reduce the amount of income subject to taxation, while exclusions remove certain revenue from taxation.

Lawmakers often choose to exempt or exclude certain revenues from taxation to promote social and economic goals, or for tax efficiency or equity purposes. Section 1 of Act 261, Session Laws of Hawai‘i (SLH) 2016, which established the annual review of tax exemptions, exclusions, and credits by the Auditor, noted that tax exemptions, exclusions, and credits reduce revenue to the state. This requires all taxpayers, including those who do not directly benefit from the exemptions, exclusions, and credits, to compensate for the reduced revenue or, alternatively, funding for state programs must be curtailed. However, the Legislature also believed that certain tax exemptions, exclusions, and credits are worthy of continuation for equity, efficiency, and economic and social policy.

Accordingly, the Legislature found the Auditor's reviews "necessary to promote tax equity and efficiency, adequacy of state revenues, public transparency, and confidence in a fair state government." The analysis and recommendations in this report aim to improve policymaking by informing lawmakers about the purposes, costs, and benefits of various tax provisions.

This report reviews the following tax provisions:

- Credit for capital goods used by a trade or business (Sections 235-110.7 and 241-4.5, HRS);
- Credit for research activity (Section 235-110.91, HRS);
- Exclusion of royalties and other income derived from a patent, copyright, or trade secret of a Qualified High Technology Business (Section 235-7.3, HRS);
- Exclusion of income and proceeds from stock options or stocks of a Qualified High Technology Business or a holding company for a Qualified High Technology Business (Section 235-9.5, HRS); and
- Deduction for adjusted eligible net income of an international banking facility (Section 241-3.5, HRS).

Chapter 235, HRS, is Hawai‘i's income tax law. Chapter 241, HRS, governs taxation of banks and other financial organizations and is generally known as the franchise tax. The tax credit for capital goods used by a trade or business under section 235-110.7, HRS, and the tax credit used by banks and other financial corporations under

section 241-4.5, HRS, are identical credits that apply to different types of taxes. Therefore, we have evaluated these two credits together for this report.

Under section 23-93, HRS, this report also was to include reviews of sections 235-17.5 and 241-4.4, HRS, which are tax credits for capital infrastructure costs; and section 235-110.3, HRS, an ethanol facility tax credit. However, these credits have since been repealed; for that reason, we did not review these credits.

As an initial comment, we note that it was difficult to determine the purposes of the tax provisions reviewed and what outcomes the Legislature intended the tax provisions to achieve without any clear indication from the statute, the bills that created the provisions, or the laws' legislative histories. Therefore, we recommend the Legislature clearly articulate the purpose of each tax provision and establish specific metrics to measure the provision's effectiveness, which will permit a more thorough and meaningful analysis when we review these provisions in the future.

We further recommend that other state agencies be tasked with performing cost-benefit analyses of the credit for capital goods used by a trade or business (Section 235-110.91, HRS) and the credit for research activity (Sections 235-110.7 and 241-4.5, HRS). While independent, objective, and well-suited to conduct performance audits and studies on the effectiveness of agency operations, we do not have ready access to the specialized economic data and resources necessary to conduct a thorough cost-benefit analysis of these and other tax credits.

Hawai‘i Taxes Discussed in this Report

In general, governments generate tax revenue from three major sources: wealth (in the form of property taxes); consumption of goods and services (in the form of sales and excise taxes); and income (via income taxes). In Hawai‘i, the vast majority of tax revenue is raised at the state level; Hawai‘i property taxes, which are assessed at the county level, are low in comparison to other states. In fiscal year (FY) 2021, the State General Fund, which is the chief operating fund of the state, realized a total of $7.13 billion in tax revenue. Most of that revenue came from two taxes: net income tax and GET. The net income tax collections, which include both individual and corporate income tax revenues, represent Hawai‘i's largest tax revenue source and accounted for $3.23 billion. GET, the second largest tax revenue source, accounted for $3.2 billion, or 45 percent of total General Fund tax revenue. The Transient Accommodations Tax, or hotel room tax, the State's third-largest revenue source, accounted for $194.1 million.

Hawai‘i’s Income Tax (Chapter 235, HRS)

Hawai‘i enacted an income tax in 1901, which would have made it the first state to adopt such a tax had it been a state at that time. Hawai‘i generally follows federal definitions for determining taxable income, but has its own exemptions, tax credits, and tax rates.

Hawai‘i taxes the income of both individuals and corporations. For taxable years beginning after December 31, 2017, the personal income tax rates ranged from 1.4 percent to 11 percent of taxable income; the income tax rates for corporations ranged from 4.4 percent to 6.4 percent.

General Excise Tax (Chapter 237, HRS) and Use Tax (Chapter 238, HRS)

While GET is regarded as a tax on gross business income, it resembles a consumption tax or sales tax in that the cost is typically passed along to consumers. However, GET is distinct from a typical sales tax in that it is a tax on the business, whereas a sales tax is a tax on the consumer that is collected by the business. GET is also distinct in that it is assessed on every business transaction – wholesale and retail – resulting in a broad tax base. By contrast, a typical sales tax only applies to retail sales of tangible goods.

For 2020, the most current tax year assessed in this report, Hawai‘i GET rates were:

- 0.15 percent on commissions from insurance sales;
- 0.5 percent on revenue received primarily by manufacturers and wholesalers, as defined by statute; and
- 4.0 percent on revenue received from all other activities including, but not limited to, the retail sale of tangible personal property (goods) or services, construction contracting, renting or leasing real or personal property, business interest income, commissions (except insurance commissions), theaters and amusements.

According to DoTax, Hawai‘i imposes an excise tax on the use in the state of property and services that are purchased from persons or entities outside Hawai‘i (who are not required to pay GET) and imported for use or resale in the state. Use Tax is assessed to the person or entity importing the goods or services at rates that vary based on whether the imported goods or services are resold or used by the importer. Similar to GET, Use Tax has a wholesale rate of 0.5 percent of the value of goods and services imported to Hawai‘i for resale and a retail rate of 4.0 percent of the value of goods and services imported for the importers’ own use or consumption.

Hawai‘i’s Franchise Tax (Chapter 241, HRS)

The franchise tax is levied in lieu of income tax and GET on banks, building and loan associations, development companies, financial corporations, financial services loan companies, trust companies, mortgage loan companies, financial holding companies, small business investment companies, and subsidiaries. The 7.92 percent tax is based on net income for the preceding year from all sources as defined by Chapter 235, HRS.

Hawai‘i Tax Credits

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 are designed to promote social welfare or to encourage certain industries or economic activities.

Because tax credits are direct reductions of tax liability, they are considered more valuable to taxpayers than ordinary deductions, which reduce a taxpayer’s taxable income. Tax credits may be refundable or nonrefundable. If a tax credit is nonrefundable, it can provide a tax benefit only to the extent that the taxpayer has a tax liability, reducing the liability by the amount of the credit. If the amount of the credit exceeds the filer’s tax liability in a particular year, the unused portion of nonrefundable credits generally can be carried forward and applied to future years’ taxes. In contrast, a taxpayer is ensured of receiving the full amount of a refundable tax credit in the year it is claimed, because if the tax credit exceeds tax liability, the taxpayer receives a check from the government for the difference. The tax credits reviewed in this report were refundable.

In tax year 2019, Hawai‘i had 22 active tax credits, according to the September 2021 DoTax Report on *Tax Credits Claimed by Hawaii Taxpayers*. There were also six expired tax credits for which excess credits from prior years could be carried forward into tax year 2019. Most nonrefundable credits that cannot be fully claimed in the year the credit is earned, because the amount of the credit exceeds the filer’s tax liability, can be carried forward and applied against tax liability in future years.

Overall, there were $300.6 million in tax credits claimed in the 2019 tax year, according to the September 2021 DoTax Report on *Tax Credits Claimed by Hawaii Taxpayers.*

In 2018, the Motion Picture, Digital Media, and Film Production Income Tax Credit was the State’s costliest tax credit with $80.23 million in claims, followed by the Renewable Energy Technologies Income Tax Credit with $70.5 million in claims.

Exclusions

Exclusions remove revenues from certain activities that were never intended to be part of a broadly defined tax base. Excluded amounts generally are not included in a taxpayer’s reported revenues and therefore not subject to taxation.

For example, the Exclusion of Royalties Derived from Patents, Copyrights, or Trade Secrets from Gross Income (Section 235-7.3, HRS) allows an individual or a "Qualified High Technology Business" (QHTB) to exclude royalties and other income derived from patents, copyrights, and trade secrets developed and arising out of a QHTB from being subject to income tax. As this provision excludes income from income tax and there is no requirement that excluded income be reported, there is no associated data from which we can determine the amount of the tax expenditure.

Deductions

Deductions reduce the amount of income subject to taxation, in contrast with exclusions that remove certain revenue from taxation. A deduction

Tax Equity and Efficiency: Finding the Balance

WE ARE REQUIRED to assess whether the tax provisions reviewed are necessary to promote or preserve tax equity or efficiency, however, Hawai‘i Revised Statutes do not define these terms. Rather, our analysis was informed by criteria developed by the U.S. Joint Committee on Taxation and from the U.S. Government Accountability Office, as detailed in the Association of International Certified Professional Accountants publication *Guiding Principles of Good Tax Policy: A framework for evaluating tax proposals.*

According to that framework, tax *efficiency* is the principle that a tax system should not unduly impede or reduce the productive capacity of the economy.

Tax *equity* is the principle of taxing similar taxpayers similarly. The concept of horizontal equity provides that two taxpayers with equal abilities to pay should pay the same amount of tax, while the concept of vertical equity provides that a person with the greater ability to pay should pay more tax.

Under the concept of efficiency, a tax system should avoid hindering economic goals, such as economic growth, capital formation, and competitiveness with other jurisdictions. A separate, but related, concept states that administrative and compliance costs should be kept low to foster effective tax administration. However, a tax provision meant to improve tax efficiency for one group of taxpayers can result in less equitable treatment of other taxpayers. For example, an exemption designed to increase economic activity in a certain industry or geographic area will reduce tax equity by providing favorable tax treatment to these activities. Therefore, lawmakers must carefully balance both principles to optimize tax policy.

As there is no standard definition for the terms "tax equity" or "tax efficiency," and because section 23-91, HRS does not define those terms, the Auditor's ability to determine whether reviewed tax provisions were necessary to promote tax equity or efficiency was a challenge. Further, the statutes establishing the framework of the Auditor's tax provision reviews do not establish the perspective from which a tax provision impacts on tax equity and efficiency should be evaluated. Accordingly, our analysis did not specifically address questions of either "equity" or "efficiency."

The concept of **horizontal equity** provides that two taxpayers with equal abilities to pay should pay the same amount of tax.

In contrast, **vertical equity** provides that a person with the greater ability to pay should pay more tax.

Source: Auditor research

is a specific amount that a taxpayer can subtract from their taxable income. Although both deductions and exclusions operate to reduce the amount of income subject to taxation, deductions generally need to be reported on a tax return or other filing, whereas exclusions do not. Therefore, generally, the amounts claimed as deductions are known, but data about the amounts claimed under exclusions are often not available.

Exemptions

Exemptions, like deductions, reduce taxable income. Generally speaking, exemptions refer to revenues from taxable activities or goods that, for policy purposes, are not subject to taxation. There are no exemptions reviewed in this report.

Analysis of Reviewed Tax Provisions

What did we review?

This report reviews two exclusions and two credits from Hawai‘i's Net Income Tax, one which also applies to Financial Institutions Tax, and one deduction from the Financial Institutions Tax.

What did we find?

We were unable to determine whether the two exclusions, two tax credits, and the deduction were achieving their purposes, primarily due to a lack of reliable data, articulated benchmarks, or other measurables.

Assessment Challenges: Lack of Data on Cost, Causation

Many challenges hindered our ability to report information and analyze the tax provisions as required under section 23-91, HRS, most significantly, the lack of available data. A lack of long-term historical data, subsequent structural changes to the tax provisions, and changing economic and technology trends precluded us from reasonably estimating use of the credits for the next three calendar years as required by section 23-91, HRS.

We were further challenged to determine the specific outcomes that were expected to be generated by the provisions. As noted throughout this report, although the legislative acts that created the provisions articulated certain purposes, none included specific metrics for objectively identifying whether those purposes had been achieved. Often, it was not clear what actual outcomes were expected.

An analysis of economic or employment benefits compared against forgone tax revenue was hampered by a variety of other factors.

Businesses that claimed these tax provisions are not required to provide justification. We also were unable to share taxpayer names and other confidential filing data with the Department of Commerce and Consumer Affairs (DCCA) and Department of Labor and Industrial Relations (DLIR) to independently identify and verify employment and payroll data for taxpayers claiming tax benefits.

Further, our analysis could not account for a variety of unintended effects. For example, it is possible that some businesses that claimed tax provisions aimed at generating economic activity may have received tax benefits for jobs they would have created irrespective of the tax break, while other jobs may have been filled by non-residents. We were likewise unable to assess the disadvantages faced by businesses and industries that were not eligible for the tax benefits. As a result of these challenges, we could not make a causal connection between any potential Hawai‘i employment or economic gains and the use of these tax provisions.

For future tax provisions, we recommend that the Legislature consider including a statement of purpose that identifies the goal, or outcome, the tax expenditure is meant to achieve, along with objective criteria for us to determine whether the tax preference is meeting that purpose.[1]

Finally, we conducted an analysis of the impact of tax provisions on low-income residents using the formula provided in the statute. However, we question whether the calculations represent the value that repeal of a particular tax credit would have for low-income residents. Although money generated from repealing a particular tax provision likely will increase tax revenues, the impact of the additional funds will not automatically accrue a benefit to low-income residents in particular, but to all residents. Therefore, to the extent that the Legislature considers a tax credit or rebate to low-income residents to offset this cost, a more accurate representation of impact may be to divide the amount of cost by all residents, not just low-income residents. Further discussion, as well as our calculations, can be found in Appendix B.

Regarding the Capital Goods Excise Tax Credit (Sections 235-110.7 and 241-4.5, HRS), to facilitate future reviews, we recommend:

1. The Legislature clearly articulate outputs, or benefits of the credit, that are intended to be accomplished, in conjunction with any future amendment to the credit.

2. The Legislature direct the Department of Business, Economic

[1] A similar approach has been taken by the State of Washington, which has noted that including this type of additional detail, such as demographics to be used to measure effectiveness, is important to facilitating future reviews.

Development and Tourism (DBEDT) and DoTax to conduct a cost-benefit analysis of the tax credit. DBEDT is better-positioned than the Auditor to conduct such an analysis due to their subject-matter expertise and ready access to relevant economic data and economic modeling computer software.

Regarding the Tax Credit for Research Activities (Section 235-110.91, HRS), to facilitate future reviews, we recommend:

1. The Legislature clearly articulate outputs, or benefits of the credit, that are intended to be accomplished, prior to extending the credit beyond its current 2024 sunset date or in conjunction with any future amendments to the credit.

2. The Legislature direct DBEDT and DoTax to conduct a cost-benefit analysis of the tax credit. Those agencies are better positioned than the Auditor to conduct such an analysis due to their subject-matter expertise and ready access to relevant economic data and computer software.

Regarding the Exclusion of Royalties Derived from Patents, Copyrights, or Trade Secrets from Gross Income (Section 235-7.3, HRS):

1. The Legislature should direct DoTax to classify royalty income from patents and copyrights excluded by this tax provision as a tax expenditure, and in conjunction, require QHTBs benefitting from the exclusion to file annual data that includes the amount of intellectual property-related tax revenue excluded from income.

Regarding the Exclusion of Stock Options from Qualified High Technology Businesses from Taxation (Section 235-9.5, HRS):

1. The Legislature should direct DoTax to classify stock option income excluded by this tax provision as a tax expenditure, and in conjunction, require QHTBs benefitting from the exclusion to file annual data sufficient to identify the tax expenditures. Also, DBEDT should consider adding questions to its tax credit survey to aid in identifying the economic impacts from QHTB stock option activity.

Regarding the Deduction for Adjusted Eligible Net Income of an International Banking Facility (Sections 241-3.5, HRS), to facilitate future reviews, we recommend:

1. The Legislature clearly articulate outputs, or benefits of the deduction, that are intended to be accomplished in conjunction with any future amendments to the deduction.

2. The Legislature allow DCCA to access relevant data on filers for this deduction to ensure that the tax incentive is properly claimed and achieving its purpose; or place responsibility for administering the deduction with DCCA; or require taxpayers claiming the deduction to file with their returns a form from DCCA's Division of Financial Institutions certifying the entity's status as an international banking facility.

3. The Legislature direct DCCA and DoTax to conduct a cost-benefit analysis of the deduction. Those agencies are better-positioned than the Auditor to conduct such an analysis due to their subject-matter expertise and ready access to relevant economic data.

Capital Goods Excise Tax Credit (Sections 235-110.7 and 241-4.5, HRS)

Tax Credit at a Glance (2019)*

Total Tax Credits Claimed	Tax Credits Claimed Against Income Tax	Tax Credits Claimed Against Income Tax By Individuals	Tax Credits Claimed Against Income Tax By Corporations	Tax Credits Claimed Against Franchise Tax
$37.7 million	$34.5 million	$8.5 million	$25.5 million	$3.2 million

Total Number of Claims**	Claims by Individuals	Claims by Corporations	Claims by Financial Corporations
4,409	3,405	842	15

Cost Per Low-Income Resident***	Meeting its Purpose?
$79.78	Unable to determine

*Note: As of October 2021, tax credit data was available only through 2019.

**Includes claims by fiduciaries and exempt organizations.

***Cost per low-income resident is the amount claimed per year divided by a low-income resident figure of 472,574 derived from DBEDT data.

Relevant Legislative History

Sections 235-110.7 and 241-4.5 HRS

1987
Act 239, Session Laws of Hawai'i (SLH) 1987, created the Capital Goods Excise Tax Credit applicable to both the income tax and franchise tax. The credit was phased in; for calendar years beginning after December 31, 1987, the applicable rate was 3 percent; and for December 31, 1988, and thereafter, the applicable rate was 4 percent.

1989
Act 7, SLH 1989, amended the income tax credit to clarify the definitions relating to the purchase of eligible property and the applicable year property is considered to be placed in service. The bill also clarified that the computation of the Capital Goods Excise Tax Credit for partnerships, shareholders, S corporations, and beneficiaries of estates and trusts shall be done at the entity level and the distribution of the tax credit shall be determined by DoTax rules.

2009
Act 178, SLH 2009, suspended the tax credit for 2009.

IN 1987, the Legislature created an income tax and franchise tax credit which in effect provided a 4 percent rebate for eligible expenses for business-to-business purchases of capital equipment, to offset excise tax paid on such equipment. In the legislative conference committee report for the bill that created the credit, the committee anticipated that a refundable tax credit for excise tax paid on capital goods would help businesses in the state in their early "cash-poor" years and promote the development of new businesses for the benefit of Hawai‘i.

From 2006 through 2019, nearly $342 million in Capital Goods Excise Tax Credits were claimed, which includes tax credits applied against both the income and franchise taxes, according to DoTax.

What does this tax credit do?

It allows a 4 percent, refundable tax credit against income tax and franchise tax liability based on the cost of eligible depreciable tangible personal property[2] used by the taxpayer in a trade or business and placed in service in Hawai‘i. The credit requires that the seller include the GET/Use Tax in the sales price of the capital goods to the taxpayer; the credit essentially reimburses the taxpayer for the GET or Use Tax that the taxpayer paid to the seller of the capital goods.

In order to be eligible, the personal property must be depreciable property with an estimated useful life or recovery period of three years or more. GET or Use Tax of 4 percent must be paid by the seller of the property in order to claim the credit, and as explained below, the taxpayer is required to retain evidence that the seller has paid GET. Tangible personal property does not include property that is an integral part of a building or structure or tangible personal property used in a foreign-trade zone. Furthermore, the credit may not be claimed on any cost used to claim the Motion Picture, Digital Media and Film Production Tax Credit, or the Renewable Energy Technologies Income Tax Credit. Also, if a deduction is taken under Section 179 of the Internal Revenue Code (with respect to election to expense certain depreciable business assets), no tax credit shall be allowed for that portion of the cost of property for which the deduction was taken. Internal Revenue Code, Section 179 allows taxpayers to deduct the cost of certain property as an expense at the time the property is placed in service, rather than depreciating it over time.

To claim the credit, a taxpayer is required to submit Department of Taxation Form N-312. Taxpayers are required to claim the credit within 12 months after the close of the taxpayer's taxable year. The instructions for Form N-312 require that the taxpayer retain evidence

[2] DoTax has provided detailed definitions and examples of what does and does not constitute property eligible for the credit in Hawai‘i Administrative Rules (HAR). See, e.g., HAR sections 18-235–110.7-03, and sections referenced therein.

that GET on the amounts paid for the equipment has been paid by the seller, (e.g., a sales invoice or contract showing GET as a separately stated component of the purchase price). Form N-312 also provides for "recapture" of the credit in the event that the capital goods for which a credit had been claimed are disposed of or ceased to be eligible property within a three-year period.

How does this tax credit work?

Hawai‘i business Aloha Candies spends $104,000 on candy packaging machinery from Hana Hou Machines. The machinery is considered to be depreciable property and $4,000 of the $104,000 purchase price is specified on the invoice as GET. Aloha Candies may claim a $4,000 credit against its income tax liability for the purchase of the eligible property. If its tax liability is less than $4,000, Aloha Candies is refunded the balance (i.e., $4,000 minus its tax liability) from the state.

What is the purpose of this tax credit?

According to a conference committee report on the bill that became Act 239, SLH 1987, it was anticipated that a refundable Capital Goods Excise Tax Credit would help business in the state and create an atmosphere that would generate new businesses for the benefit of Hawai‘i. DoTax classifies this as a "credit to avoid double taxation or pyramiding," as it effectively negates GET liability on business-to-business transactions. As DoTax explains in its report on tax credits, the cost of such capital equipment is expected ultimately to be recaptured in the price of goods or services produced, so without the rebate, the price of the produced goods or services would include the tax on the capital equipment. While DoTax classifies this as a "credit to avoid double taxation or pyramiding," we note that is not the purpose of the credit as stated by the Legislature. Moreover, we disagree with DoTax's position that the tax credits reduce or otherwise address tax pyramiding. In contrast to goods or services that are directly incorporated into a product sold to the consumer, the credit applies to depreciable property with a useful life of at least three years. The GET cost paid by a business to a seller of such equipment, like other costs associated with running a business such as electricity and lease rent, is at most indirectly passed to consumers.

Is this tax credit meeting its purpose?

Based on available data, the credits are well-utilized. However, concrete conclusions about whether the credit is appropriately utilized or achieves its stated purpose of generating new business cannot be drawn. Explicit metrics or benchmarks for gauging the impact of the credits on Hawai‘i businesses may help, although obtaining data on business activity sufficient to verify the necessity of the credit may be difficult. As it stands, we are unable to determine whether the credit has resulted in new business generation or the expansion of existing businesses.

What were the number of claimants and total amount claimed for this tax credit from 2017-2019?

Year	Total Number of Claims	Total Tax Credits Claimed	No. of Claims by Financial Corporations	Tax Credits Claimed Against Franchise Tax	No. of Claims by Individuals	Tax Credits Claimed by Individuals
2019	4,060	$37.7 million	15	$3.2 million	3,405	$8.5 million
2018	4,340	$34.1 million	15	$3 million	3,290	$8.5 million
2017	4,409	$29.3 million	*Data Suppressed	*Data Suppressed	3,089	$6.3 million

* Data suppressed by DoTax to avoid potential disclosure of confidential taxpayer information.

Source: DoTax 2017 and 2018 *Tax Credits Claimed by Hawai‘i Taxpayers* reports

For 2019, $8.5 million in tax credits were claimed by 3,405 individuals, an average of $2,496 per claim. This ratio may be a reflection of Hawai‘i’s many small businesses that are sole proprietorships, single-member limited liability companies (LLCs), partnerships, multi-member LLCs, and S corporations, according to DoTax. A business operating as such an entity would claim the credit on an individual return as, even if an entity level return must be filed, the credit would flow through to an individual.

Is there an economic or employment benefit to Hawai‘i and if so, does the benefit outweigh the cost of the credit?

Claimants of this tax credit must report in-state and out-of-state purchases, but are not required to report on any economic benefits such as job creation or wages that accrue or result from the tax credits. Therefore, we are unable to quantify any economic benefits resulting from this tax credit, or whether such benefits outweigh the costs.

Should the tax credit be retained without modification, amended, or repealed?

We cannot quantify any economic or employment benefits of the tax credits, (i.e., whether the credit generated new businesses in the state), nor determine any causal connection between any purported benefits and the stated purposes of the credit. The Legislature should consider clearly articulating the purposes of the Capital Goods Excise Tax Credit, the outcomes that are expected to be generated, and benchmarks for evaluating whether outcomes are being achieved at desired levels.

Tax Credit for Research Activities (Section 235-110.91, HRS)

Tax Credit at a Glance (2019)*

Tax Credits Claimed	Number of Claims	Cost Per Low-Income Resident	Meeting its Purpose?
$3.8 million	52	$8.04**	Unable to determine

*Note: As of October 2021, tax credit data was available only through 2019.

**Cost per low-income resident used is the amount claimed per year divided by a low-income resident figure of 472,574 derived from DBEDT data.

Relevant Legislative History

- **1999**
  Act 178, SLH 1999, created an income tax credit for "increasing" research activities (increased spending year-over-year, as opposed to total amounts spent on research). The tax credit was limited to 2.5 percent of new research expenses in Hawai'i and was non-refundable. It was modeled after a federal income tax credit for increasing research activities. The measure was included in a larger bill intended to spur economic development and foster the growth of knowledge-based industries in Hawai'i via tax policy, special purpose revenue bonds, and other incentives.

- **2000**
  Act 297, SLH 2000, raised the amount of the credit from 2.5 percent to 20 percent of qualified research expenses to match changes to the federal standard, and also made the credit refundable.

- **2001**
  Act 221, SLH 2001, removed the requirement for increasing research (i.e., it allowed the credit to be claimed for all qualified research expenses, without regard to the amount of expenses for previous years, not just the incremental amount).

- **2004**
  Act 215, SLH 2004, extended the credit for another five years, to 2010, and limited the credit to Qualified High Technology Businesses, not all taxpayers. The act created a certification process within DoTax and limited credit eligibility to businesses that met the Qualified High Technology Business definition.

- **2010**
  The Tax Credit for Research Activities sunsets.

- **2013**
  After the Tax Credit for Research Activities had sunsetted in 2010, Act 270, SLH 2013, reestablished the credit for research activities equal to 20 percent of qualified research expenses incurred in Hawai'i with a sunset date of December 31, 2019. This Act amended the definition of QHTBs and adopted federal rules again for eligibility, which meant that qualified research expenses were limited to incremental amounts only. The Act mandated all QHTBs that claim the credit to complete an annual survey with DBEDT. Based on the survey, DBEDT was required to submit a report to the Legislature, using the information collected to study the effectiveness of the Tax Credit for Research Activities.

- **2019**
  Act 261, SLH 2019, removed the requirement for increasing research (i.e., it allowed the credit to be claimed for all qualified research expenses, not just the incremental amount year-over-year). It also capped annual credits at $5 million per year, with credits being certified by DBEDT on a first-come, first-serve basis. The sunset date for the credit was extended from 2019 to 2024.

“Act 221” Credits

SOME OF THE TAX PROVISIONS reviewed in this report were expanded in 2001 under Act 221, which also included high technology investment tax credits that have become known as “Act 221” credits. The Legislature passed Act 221, (which, as we noted in our Report No. 12-05, *Audit of the Department of Taxation’s Administrative Oversight of High Technology Business Investment and Research Activities Tax Credits)*, 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. A taxpayer could claim a maximum investment credit of $2 million over five years. The investment tax credit and research tax credit enacted in 1999 were significantly increased the next year and are generally referred to by their enactment title of Act 221. Both of those provisions sunsetted in 2010. The “Act 221” credits have been the subject of much debate and criticism, and should not be equated to the research activity credits and other credits assessed in this report.

The Credit for Research Activities assessed in this report was reestablished in 2013, is significantly different from the predecessor credit, and is scheduled to sunset in 2024. The research activity credits discussed in this report remain part of the tax code and are separate and distinct from the investment credits that sunsetted in 2010.

What does the tax credit do?

Qualified High Technology Businesses (QHTB) subject to Hawai‘i income tax can claim a refundable 20 percent income tax credit for qualified research activities, provided that the QHTB also claims the federal tax credit for the same qualified research activities. Qualified research expenses include only those research expenses incurred in Hawai‘i and those expenses are certified by DBEDT as eligible for the tax credit. The maximum annual aggregate amount available for the Tax Credit for Research Activities is $5 million and requests to certify the research expenses are considered by DBEDT on a first-come, first-served basis until the cap is reached.

To claim the credit, a taxpayer must submit Department of Taxation Forms N-346 (Tax Credit for Research Activities) and N-346A (Certified Statement of Research and Development Costs Incurred by a (QHTB) and Claim of the Tax Credit for Research Activities). Form N-346A includes a certification by *DBEDT* (not the taxpayer) that the QHTB must obtain of eligible research expenses and the amount of the credit. In order to obtain the credit, the QHTB must also attach a copy of Internal Revenue Service Form 6765 to verify that the federal tax credit has been claimed for the same research activities. In Announcement No. 2021-03, issued in January 2021, DoTax describes a two-step application and certification process for the credit. Applications were accepted for the 2020 tax year by online submission only, starting March 1, 2021, at 9:00 a.m. Step 1 requires submitting a fully completed and executed Form N-346A to DBEDT; the order in which the forms were received determined the order in which credits were allocated. Step 2 requires taxpayers to complete an online questionnaire no later than March 31, 2021. After reviewing the applications and information, DBEDT is to return Form N-346A to qualifying taxpayers specifying the amount of the allowed credit.

How does the tax credit work?

Aloha HI-Tech, a hypothetical QHTB, incurred $1 million on new research to develop software applications, a qualified research activity and claimed a research tax credit against its federal income tax liability. DBEDT certifies the full amount of the credit. The company can claim a $200,000 income tax credit against its Hawai‘i 2020 income taxes and receive the credit in the form of a refund if the amount of tax credit exceeds the company’s tax liability.

What is the purpose of the tax credit?

The purpose, according to the 1999 Act that first established the credit, is to support the growth and development of high technology industries in Hawai‘i. It was an attempt to capitalize on new opportunities for the state to develop and diversify its economy, while opening the global market to Hawai‘i businesses.

According to one committee report, the underlying bill was the committee's commitment to fostering high technology growth and development in Hawai‘i to ensure Hawai‘i's prominent role as a mecca for high technology companies and a world-renowned center for innovation and invention.

In the 2013 Act that reestablished the credit, the Legislature noted the credit will provide support for scientific experimentation; help bridge any funding gap between federal early stage research funding and the critical product development and validation stage; and contribute to the diversification of the economy by creating and maintaining science, technology, engineering, and mathematics jobs in Hawai‘i.

Is the tax credit meeting its purpose?

Hawai‘i technology businesses provide unverified economic data on a questionnaire submitted to DBEDT as part of the application process to claim the credits. Therefore, we cannot determine whether the self-reported levels of business economic activity attributed to the tax credit are achieving the levels envisioned by the Legislature when it extended the tax credit. However, there are no obvious indications that Hawai‘i has achieved a prominent role as a "mecca for high-technology companies," or has become a "world-renowned center for innovation and invention," as was envisioned by the Legislature.

We note that three recent rankings of high technology business centers failed to even mention Hawai‘i, let alone cite the state as a mecca for high-tech. These include a January 21, 2021, *Fortune* article titled "Where to Invest in Real Estate: The 10 hottest tech meccas beyond Silicon Valley," and a May 2019 article in *PC Magazine* titled "20 High-Tech Cities You'll Want to Call Home," neither of which mentioned any locations in Hawai‘i. Similarly, a March 2019 article on the website *24/7 Wall St.* titled "15 Cities With the Most High-Tech Jobs," which ranked cities based on their concentration of science, technology, engineering, and math jobs, did not mention Hawai‘i.

The credit can be an effective policy instrument to increase research and development spending by Hawai‘i technology firms according to a January 2021 brief on the research tax credit prepared by the University of Hawai‘i Economic Research Organization (UHERO). However, the

brief noted that, in 2018, the tax credit program operated at a very small scale, with the clear implication that the program "cannot substantially contribute to future economic growth." Among other things, UHERO recommended substantially increasing the annual cap on such credits in the future.

What were the number of claimants, and total amount claimed for this tax credit from 2017-2019?

Year	Total Number of Claims	Tax Credits Claimed
2019	52	$3.8 million
2018	54	$2.4 million
2017	54	$2.5 million

Source: DoTax 2017, 2018, and 2019 *Tax Credits Claimed by Hawai‘i Taxpayers* reports

Is there an economic or employment benefit to Hawai‘i and if so, does the benefit outweigh the cost of the credit?

The application process for this tax credit requires taxpayers to complete an online questionnaire in conformance with section 235-110.91(j), HRS, that includes:

- The applicant's Hawai‘i employment and wage data, including the number of full-time and part-time employees retained, new jobs, temporary positions, external services procured by the business, and payroll taxes;
- Filed intellectual property, including invention disclosures, provisional patents, and patents issued or granted; and
- The number of new companies spun out or established to commercialize the intellectual property owned by the Qualified High Technology Business.

DBEDT, which is required to report this information to the Legislature, includes statistics on QHTBs' various activities in its *Report on Hawaii Tax Credit for Research Activities for Tax Year 2019* and the economic benefits that QHTBs attribute to the tax credit. For example:

- A total of 66 patents were owned or filed by seven QHTBs as of December 2019 (39 owned, 27 pending).

- In 2019, 10 QHTBs generated a combined total of $101 million in revenue from all goods and services produced in Hawai‘i, of which 54.3 percent ($54.8 million) was derived from out-of-state sales or activities.

- As of December 12, 2019, 10 QHTBs had a total of 437 regular employees. Of the regular employees, 92.2 percent were full-time employees. The majority also worked in research sectors. About three out of four non-temporary or non-seasonal hires were employed in research sectors, which was true for both full-time and part-time jobs.

Should the tax credit be retained without modification, amended, or repealed?

Although the tax credit is set to sunset in 2024, the Legislature has extended the incentive in the past.

Concrete conclusions about whether the credit achieves its purposes cannot be drawn until or unless the Legislature identifies metrics or benchmarks for gauging its impact on Hawai‘i’s technology industry and Hawai‘i’s economy. We recommend the Legislature consider articulating the level of activity the credit is expected to generate in the form of targeted outcomes and benchmarks prior to extending the credit beyond its current 2024 sunset date.

Exclusion of Royalties Derived from Patents, Copyrights, or Trade Secrets from Gross Income (Section 235-7.3, HRS)

Exclusion at a Glance

Amount claimed	Number of Claims	Tax Expenditure	Cost Per Low-Income Resident	Meeting its Purpose?
No data available	No data available	No data available	Cannot be calculated	Unable to determine

Relevant Legislative History

- **1999**
  Act 178, SLH 1999, created a provision to exclude patent and copyright royalties and other income from high technology business gross income. The measure was included in a larger bill, the purpose of which was to spur economic development and foster the growth of knowledge-based industries in Hawai‘i via tax incentives, special purpose revenue bonds, and other incentives.

- **2000**
  Act 297, SLH 2000, amended the exclusion to include income derived from patents, copyrights, or trade secrets; and clarified and increased the definition of “qualified research” to include performing arts products (including TV commercials and audio recordings), biotechnology, and computer software development and design.

- **2001**
  Act 221, SLH 2001, further amended the exclusion to apply to authors of performing arts products, and the assignors, licensors, and licensees of any copyright rights in performing arts products.

What does this exclusion do?

The Exclusion for Royalties Derived from Patents, Copyrights, or Trade Secrets from Gross Income excludes amounts received by an individual or a QHTB as royalties and other income derived from patents, copyrights, and trade secrets owned by the individual or QHTB and developed and arising out of a QHTB from gross income, adjusted gross income, and taxable income. The exclusion also applies to authors of performing arts products or any parts thereof; and the assignors, licensors, and licensees of any copyright in performing arts products or any parts thereof. The exclusion defines royalties and other income from patents, copyrights, and trade secrets as outside the scope of the Hawai‘i income tax, and therefore DoTax does not require such income to be reported. A QHTB is defined as a business that conducts more than 50 percent of its business in certain qualified research in activities such as computer software development, biotechnology, or performing arts products.

How does this exclusion work?

Aloha Filters, a hypothetical QHTB based in Hawai‘i, develops a unique water filtration technology for which it is awarded a patent. Aloha Filters enters into license agreement with Mahalo Springs Bottling, another hypothetical Hawai‘i business, to use its patented water filtration technology for $1 million annually. Income from this license agreement would be subject to Hawai‘i income tax; however, because of the exclusion, the income from the license agreement is excluded from Aloha Filters’ gross income, adjusted gross income, and taxable income for Hawai‘i income tax purposes. That means Aloha Filters does not pay Hawai‘i income tax on the income earned from the license agreement.

What is the purpose of this exclusion?

According to Act 178, SLH 1999, the purpose was to support the growth and development of high technology industries in Hawai‘i. It was an attempt to capitalize on new opportunities for the state to develop and diversify its economy, while opening the global market to Hawai‘i businesses.

Is the exclusion meeting its purpose?

DBEDT's *Report on Hawaii Tax Credit for Research Activities for Tax Year 2020* includes statistics on intellectual property owned by QHTBs. According to that report, as of December 2020, a total of 1,843 patents were reported to be owned or pending by 40 QHTBs. However, 85 percent of the patents were owned by a single mainland-based company. Additionally, more than half of the QHTBs did not own a single patent.

On average, surveyed QHTBs earned about half of their revenue from intellectual property, including copyrights, trade secrets, and trademarks produced in Hawai‘i. Presumably, these QHTBs utilized the Exclusion of Royalties from Patents, Copyrights, and Trade Secrets to reduce their respective Hawai‘i income that is subject to Hawai‘i income tax liability. However, we are unable to determine whether there is a causal connection between the exclusion and the purpose of supporting the growth and development of high technology industries in Hawai‘i. DBEDT's report covered data from QHTBs gathered in connection with the research credit (which is not available to individuals), so there is no similar data available for individuals who benefit from the exclusion of royalty income.

What were the number of claimants, total amount claimed, and tax expenditures for this exclusion from 2018-2020?

This provision is an exclusion from income tax and DoTax does not require taxpayers claiming the exclusion to report amounts of excluded income. Therefore, DoTax does not collect data to determine the amount of tax expenditure associated with the exclusion. Additionally, DoTax does not believe the excluded income was meant to be part of the state's tax base and, for that reason, does not consider the amounts excluded from taxation to be tax expenditures. However, we question DoTax's position that this exclusion results in no tax expenditure. Based on legislative history, the Legislature's decision to exclude patent, copyright, and trade secret income from taxation was to stimulate the high-tech industry. Therefore, this exclusion appears to differ from other exclusions that apply to revenue never intended to be subject to taxation.

Is there an economic or employment benefit to Hawai‘i and if so, does the benefit outweigh the cost of the exclusion?

Although we determined that the primary purpose is to support economic growth, we are unable to identify any benefits directly resulting from this exclusion. There is no requirement that excluded revenue be reported, and there is no associated tax expenditure data; therefore, we cannot determine whether any benefits attributed to the exclusion outweigh costs.

Should the exclusion be retained without modification, amended, or repealed?

We do not have sufficient information to analyze whether the exclusion should be retained, especially without data on associated forgone tax revenue. If this data is deemed important, DoTax should consider requiring the income that is being excluded to be reported and deducted on income tax returns or require QHTBs benefitting from the exclusion to submit the amount of revenue derived from patents, trademarks, and trade secrets excluded from gross income.

Exclusion of Stock Options from Qualified High Technology Businesses from Taxation (Section 235-9.5, HRS)

Exclusion at a Glance

Amount claimed	Number of Claims	Tax Expenditure	Cost Per Low-Income Resident	Meeting its Purpose?
No data available	No data available	No data available	Cannot be calculated	Unable to determine

Relevant Legislative History

1999
Act 178, SLH 1999, created the provision exempting from taxation stock options from a "Qualified High Technology Business" (QHTB). The measure was included in a larger bill, the purpose of which was to spur economic development and foster the growth of knowledge-based industries in Hawai'i via tax incentives, special purpose revenue bonds, and other incentives.

2000
Act 297, SLH 2000, amended the exclusion to include income from an officer, director, or investor in a company qualifying for investment tax credits, clarified the types of software eligible as qualified research, and added biotechnology as a qualified research category.

2001
Act 221, SLH 2001, further amended the provision by calling it an exclusion (rather than exemption) and expanded the definition of eligible income to include earned income and proceeds derived from stock options or stock, including stock issued through the exercise of stock options or warrants, from a QHTB or from a holding company of a QHTB. The terms "holding company" and "income earned and proceeds derived from stock options or stock" were also defined.

What does this exclusion do?

The Exclusion of Stock Options from Qualified High Technology Businesses from Taxation excludes from taxation all income earned and proceeds derived by an employee, officer, director, or qualifying investor from stock options or stock from a Qualified High Technology Business or from a holding company of a QHTB. Similar provisions apply to options to acquire equity interests and to equity interests themselves in entities other than corporations.

How does this exclusion work?

John Smith, an employee of Aloha Ventures, a hypothetical QHTB, receives company stock options as part of his compensation. He later exercises the stock options, resulting in $100,000 in capital gain, which is ordinarily subject to income tax. However, given the exclusion, Smith is not required to report that capital gain income for Hawai'i income tax purposes.

What is the purpose of this exclusion?

The purpose of the enabling Act was to support the growth and development of high technology industries in Hawai‘i. The measure was meant to spur economic development and foster the growth of knowledge-based industries in Hawai‘i via tax incentives, special purpose revenue bonds, and other incentives.

Is the exclusion meeting its purpose?

We are unable to determine whether this exclusion achieves the purposes for which it was adopted as there is no data available on whether and to what extent it is utilized. DBEDT's August 2021 *Report on Hawaii Tax Credit for Research Activities for Tax Year 2020* does not include statistics on stock options provided by QHTBs that responded to the 2020 research activity tax credit survey.

What were the number of claimants, total amount claimed, and tax expenditures for this exclusion from 2018-2020?

There is no requirement that taxpayers report the income earned from stock options or stock from QHTBs. For that reason, there are no associated data or tax expenditure amounts for the exclusion collected or reported by DoTax, which does not consider amounts excluded from taxation to be tax expenditures. However, we question DoTax's position that this exclusion results in no tax expenditure. Based on legislative history, the Legislature's decision to exclude stock option gains from taxation was to stimulate the high-tech industry. This income would otherwise be subject to taxation; therefore, this exclusion appears to differ from other exclusions that apply to revenue never intended to be subject to taxation.

Is there an economic or employment benefit to Hawai‘i and if so, does the benefit outweigh the cost of the exclusion?

Although we determined that the primary purpose is to support technology sector growth, we are unable to identify the benefits resulting from this exclusion including whether it has helped generate more high-tech companies to locate or start-up in Hawai‘i, or the number of employees that those companies have hired. Further, as this provision excludes revenue from income tax and there is no requirement that excluded revenue be reported, there is no associated data upon which to base a cost-benefit analysis.

Should the exclusion be retained without modification, amended, or repealed?

We do not have sufficient information to analyze whether the exclusion should be retained, and therefore suggest the following steps be taken to aid in future analysis of this tax provision. DoTax should consider classifying income excluded by this tax provision as a tax expenditure, and in conjunction, require QHTBs benefitting from the exclusion to provide data that includes the amount of qualifying stock option income excluded from taxation. Also, DBEDT should consider adding questions to its tax credit survey to better identify the value and utilization of this exclusion to aid in identifying the economic impacts from QHTB stock option activity.

Deduction for Adjusted Eligible Net Income of an International Banking Facility (Section 241-3.5, HRS)

Deduction at a Glance

Amount claimed	Number of Claims	Tax Expenditure	Cost Per Low-Income Resident	Meeting its Purpose?
Confidential*	Confidential*	Confidential*	Confidential*	Cannot be determined

*Note: To prevent people from identifying, directly or indirectly, a particular taxpayer, DoTax does not disclose tabulations containing data for 5 or fewer returns at the state level, 10 or fewer returns at the county level, or individual returns that represent a large percentage of any tabulation.

Relevant Legislative History

1983

Act 278, SLH 1983, created the deduction.

What does this deduction do?

The Deduction for Adjusted Eligible Net Income of an International Banking Facility allows an international banking facility, as defined in section 412:5-206, HRS, to deduct “adjusted eligible net income” from the franchise tax. Under section 412:5-206, HRS, an international banking facility is defined as “a set of international banking accounts under Regulation D of the Federal Reserve Board.” A bank may establish an international banking facility without prior approval but must furnish the Commissioner of Financial Institutions (commissioner) copies of a statement of intention and quarterly reports required under regulation D. Qualified banks that are authorized to operate international banking facilities can deduct eligible net income from international banking facility operations on its franchise tax filings.

The deduction is claimed on Department of Taxation Form F-1 (Franchise Tax Return) and reported as an allowable deduction from net income under “other deductions.”

What is the purpose of this deduction?

The purpose of the deduction created by Act 278, SLH 1983, was to promote the establishment of international banking facilities in Hawai‘i to make loans to or accept deposits from certain foreign customers free from state and county taxes. The Legislature believed that international banking facilities would promote foreign investment (especially from Asia), promote Hawai‘i as a financial center, and not pose a threat to domestic financial institutions.

Is the deduction meeting its purpose?

According to DoTax, the deduction was utilized from 2017 through 2020 and details on those claims were provided to the Auditor. However, DoTax said data on the number and amount of deductions claimed could not be publicly disclosed, as such a release could jeopardize taxpayer confidentiality. To prevent the identification, directly or indirectly, of a particular taxpayer, DoTax does not disclose consolidated data where there are five or fewer taxpayers, or the tax returns of one or a few taxpayers represent a large percentage of the data. These confidentiality concerns also apparently precluded disclosure of international banking facility taxpayer information to the Department of Commerce and Consumer Affairs' Division of Financial Institutions (DFI), which provides regulatory oversight for Hawai‘i's financial service providers. Section 412:5-206, HRS, requires any bank intending to operate an international banking facility in Hawai‘i to file a notice of intention with the commissioner and subsequently file quarterly reports with the commissioner.

While DoTax reported that the deduction has been claimed as recently as 2020, the commissioner has no records of any international banking facilities located in Hawai‘i. We also asked the commissioner if DFI had any records of statements of intention or quarterly reports as required of banks that establish international banking facilities, and were told DFI had no such records. Although the Auditor had access to confidential data regarding the deduction, we are unable to evaluate the legitimacy of the claimed deduction and believe the commissioner is better positioned to evaluate the legitimacy of such claims and to determine whether this tax provision is meeting its purpose. However, per DoTax's direction, we were not allowed to share data on the deduction with the commissioner.

What were the number of claimants, total amount claimed, and tax expenditures for this deduction from 2018-2020?

DoTax said data on the number and amount of deductions claimed cannot be publicly disclosed. According to DoTax, because the number of claimants is less than five, public disclosure of the information relating to this deduction, including the number of claimants and the total amount claimed, could jeopardize taxpayer confidentiality.

Is there an economic or employment benefit to Hawai‘i and if so, does the benefit outweigh the cost of the deduction?

Although we determined that the primary purpose is to promote foreign investment and promote Hawai‘i as a financial center, we are unable to identify the benefits of this deduction. Although DoTax has data indicating that the deduction is being used, the commissioner did not have any records required to be filed by international banking facilities. The identities of entities claiming the deduction cannot be shared with other relevant state agencies such as the DCCA or Department of Labor and Industrial Relations which undermines any attempt to identify employment impacts.

Should the deduction be retained without modification, amended, or repealed?

The Legislature should consider specifying that DoTax verify data on filers with the commissioner and other relevant state agencies, or require taxpayers taking the deduction to provide this verification to ensure that the tax incentive is properly claimed. The Legislature should also consider establishing criteria for evaluating whether the deduction achieves its purpose. Alternatively, the Legislature could consider placing responsibility for administering the deduction with the commissioner or requiring beneficiaries of the deduction to obtain the commissioner’s certification in conjunction with any future claims for the deduction.

Issues of concern

DFI does not currently have access to DoTax information about businesses claiming the deduction and, therefore, is unable to confirm to DoTax or others, including the Legislature, that the deduction is being claimed appropriately. While DoTax reports that some taxpayers are claiming this deduction that was meant to encourage establishment of Hawai‘i-based international banking facilities, however DFI was unaware of any such facilities operating in Hawai‘i.

Recommendations

Regarding the Capital Goods Excise Tax Credit (Sections 235-110.7 and 241-4.5, HRS), to facilitate future reviews, we recommend:

1. The Legislature clearly articulate outputs, or benefits of the credit, that are intended to be accomplished, in conjunction with any future amendment to the credit.

2. The Legislature direct DBEDT and DoTax to conduct a cost-benefit analysis of the tax credit. DBEDT is better-positioned than the Auditor to conduct such an analysis due to their subject-matter expertise and ready access to relevant economic data and economic modeling computer software.

Regarding the Tax Credit for Research Activities (Section 235-110.91, HRS), to facilitate future reviews, we recommend:

1. The Legislature clearly articulate outputs, or benefits of the credit, that are intended to be accomplished, prior to extending the credit beyond its current 2024 sunset date or in conjunction with any future amendments to the credit.

2. The Legislature direct DBEDT and DoTax to conduct a cost-benefit analysis of the tax credit. Those agencies are better positioned than the Auditor to conduct such an analysis due to their subject-matter expertise and ready access to relevant economic data and computer software.

Regarding the Exclusion of Royalties Derived from Patents, Copyrights, or Trade Secrets from Gross Income (Section 235-7.3, HRS):

1. The Legislature should direct DoTax to classify royalty income from patents and copyrights excluded by this tax provision as a tax expenditure, and in conjunction, require QHTBs benefitting from the exclusion to file annual data that includes the amount of intellectual property-related tax revenue excluded from income.

Regarding the Exclusion of Stock Options from Qualified High Technology Businesses from Taxation (Section 235-9.5, HRS):

1. The Legislature should direct DoTax to classify stock option income excluded by this tax provision as a tax expenditure, and in conjunction, require QHTBs benefitting from the exclusion to file annual data sufficient to identify the tax expenditures. Also, DBEDT should consider adding questions to its tax

credit survey to aid in identifying the economic impacts from QHTB stock option activity.

Regarding the Deduction for Adjusted Eligible Net Income of an International Banking Facility (Sections 241-3.5, HRS), to facilitate future reviews, we recommend:

1. The Legislature clearly articulate outputs, or benefits of the deduction, that are intended to be accomplished in conjunction with any future amendments to the deduction.

2. The Legislature allow DCCA to access relevant data on filers for this deduction to ensure that the tax incentive is properly claimed and achieving its purpose; or place responsibility for administering the deduction with DCCA; or require taxpayers claiming the deduction to file with their returns a form from DCCA's Division of Financial Institutions certifying the entity's status as an international banking facility.

3. The Legislature direct DCCA and DoTax to conduct a cost-benefit analysis of the deduction. Those agencies are better-positioned than the Auditor to conduct such an analysis due to their subject-matter expertise and ready access to relevant economic data.

Appendix A

Schedule of Tax Statutes for Review

Sections 23-71 through 23-81, HRS
Sections 23-91 through 23-96, HRS

Deadline	HRS Ref.	Statute to be reviewed	Notes
2022 Session	23-74	239-2, paragraph (5)	Definition of "gross income"--Gross income of home service providers of mobile telecommunications services
		239-2	Exclusions under the definition of "gross income"--Dividends paid by one member to another member of an affiliated public service company group or gross income from the sale or transfer of materials and supplies, interest on loans, and provision of services among members of an affiliated public service company group
		237-3(b)	Gross receipts from the sale or transfer of materials and supplies, interest on loans, and provision of services among members of an affiliated public service company group*
		239-5.5	Gross income of utilities from monthly surcharges
		239-6.5	Tax credit for lifeline telephone service subsidies
		269-172	Green infrastructure charges received by electric utilities
		237-29.7	Gross income or gross proceeds received by insurance companies
		431:7-207	Tax credit to facilitate regulatory oversight
		432:1-403	Exemption for nonprofit medical indemnity or hospital service associations or societies specifically from the general excise tax, public service company tax, or insurance premium tax
		432:2-503	Exemption for fraternal benefit societies specifically from the general excise tax, public service company tax, or insurance premium tax
	23-93	235-7.3	Exclusion of royalties and other income derived from a patent, copyright, or trade secret of a qualified high technology business
		235-9.5	Exclusion for income and proceeds from stock options or stocks of a qualified high technology business or a holding company for a qualified high technology business
		235-17.5	Credit for capital infrastructure costs
		241-4.4	Credit for capital infrastructure costs
		235-110.7	Credit for capital goods used by a trade or business
		241-4.5	Credit for capital goods used by a trade or business
		235-110.91	Credit for research activity
		235-110.3	Credit for ethanol facility
		241-3.5	Deduction for adjusted eligible net income of an international banking facility

* Note: This exemption was reviewed in the report to the 2020 Legislature

Report Date	HRS Ref.	Statute to be reviewed	Notes
2023 Session	23-75	237-24.3(1)	Amounts received from loading, transporting, and unloading agricultural commodities shipped interisland
		237-24.3(3)(A)	Amounts received from cargo loading or unloading
		237-24.3(3)(B)	Amounts received from tugboat and towage services
		237-24.3(3)(C)	Amounts received from the transportation of pilots or government officials and other maritime-related services
		238-1, paragraph (7)	Definition of “use”--The value of oceangoing vehicles for transportation from one point to another in the State
		238-3(g)	The value of imported intoxicating liquor and cigarettes and tobacco products for sale to persons or common carriers in interstate commerce
		238-3(h)	The value of vessels constructed under section 189-25, relating to commercial fishing vessel loans, prior to July 1, 1969
		237-28.1	Gross proceeds from shipbuilding and ship repair
	23-94	235-4.5(a)	Exclusion of intangible income earned by a trust sited in this State
		235-4.5(b)	Exclusion of intangible income of a foreign corporation owned by a trust sited in this State
		235-4.5(c)	Credit to a resident beneficiary of a trust for income taxes paid by the trust to another state
		235-55	Credit for income taxes paid by a resident taxpayer to another jurisdiction
		235-129	Credit for income taxes paid by a resident taxpayer to another jurisdiction
		235-71(c)	Credit for a regulated investment company shareholder for the capital gains tax paid by the company
		235-110.6	Credit for fuel taxes paid by a commercial fisher
		235-110.93	Credit for important agricultural land qualified agricultural cost
		235-110.94	Credit for organically produced agricultural products
		235-129(b)	Credit to a shareholder of an S corporation for the shareholder’s pro rata share of the tax credit earned by the S corporation in this State
		209E-10	Credit for a qualified business in an enterprise zone; provided that the review of this credit pursuant to this part shall be limited in scope to income tax credits

Report Date	HRS Ref.	Statute to be reviewed	Notes
2024 Session	23-76	237-24.3(4)	Amounts received by employment benefit plans and amounts received by nonprofit organizations or offices for the administration of employee benefit plans
		237-24.3(5)	Amounts received from food coupons under the federal food stamp program or vouchers under the Special Supplemental Foods Program for Women, Infants and Children
		237-24.3(6)	Amounts received from the sale of prescription drugs or prosthetic devices
		237-24.3(8)	Amounts received as dues by unincorporated merchants associations for advertising or promotion
		237-24.3(9)	Amounts received by labor organizations from real property leases
		237-24.75(2)	Reimbursements to the Hawai‘i convention center operator from the Hawai‘i Tourism Authority
		237-24.75(3)	Reimbursements to professional employer organizations from client companies for employee wages and fringe benefits
		209E-11	Amounts received by qualified businesses in enterprise zones
	23-95	235-5.5	Deduction for individual housing account deposit
		235-7(f)	Deduction of property loss due to a natural disaster
		235-16.5	Credit for cesspool upgrade, conversion, or connection
		235-19	Deduction for maintenance of an exceptional tree
		235-55.91	Credit for the employment of a vocational rehabilitation referral
		235-110.2	Credit for in-kind services contribution for public school repair and maintenance
		235-110.8	Credit for ownership of a qualified low-income housing building
		241-4.7	Credit for ownership of a qualified low-income housing building

Report Date	HRS Ref.	Statute to be reviewed	Notes
2025 Session	23-77	237-24.3(2)	Reimbursements to associations of owners of condominium property regimes or nonprofit homeowners or community associations for common expenses
		237-24.5	Amounts received by exchanges or exchange members*
		237-25(a)(3)	Gross income received from tangible personal property sales to state-chartered credit unions
		237-24.8	Amounts received by financial institutions, trust companies, trust departments, or financial corporations acting as interbank brokers
		237-26	Gross proceeds of scientific contractors and subcontractors
		238-3(j)	The value of property or services exempted by section 237-26, relating to scientific contracts
		237-27	Amounts received by petroleum product refiners from other refiners
	23-96	235-15	Credit for purchase of child passenger restraint system
		235-55.6	Credit for employment-related expenses for household and dependent care services
		235-55.7	Credit for a low-income household renter
		235-55.85	Credit for food and excise tax
2026 Session	23-78	237-24.7(1)	Amounts received by hotel operators and hotel suboperators for employee wages and fringe benefits
		237-24.7(2)	Amounts received by a county transportation system operator under a contract with the county
		237-24.7(4)	Amounts received by orchard property operators for employee wages and fringe benefits
		237-24.7(6)	Amounts received from insurers for damage or loss of inventory of businesses located in a natural disaster area
		237-24.7(7)	Amounts received by community organizations, school booster clubs, and nonprofit organizations for precinct and other election-related activities
		237-24.7(8)	Interest received by persons domiciled outside the State from trust companies acting as payment agents or trustees on behalf of issuers or payees of interest-bearing instruments or obligations
		237-24.7(9)	Amounts received by management companies from related entities engaged in interstate or foreign common carrier telecommunications services for employee wages and fringe benefits
		237-24.7(10)	Amounts received from high technology research and development grants
	23-92	235-12.5	Credit for renewable energy technology system installed and placed in service in the State. For the purpose of section 23-91(b)(5), this credit shall be deemed to have been enacted for an economic benefit
		241-4.6	Credit for renewable energy technology system installed and placed in service in the State. For the purpose of section 23-91(b)(5), this credit shall be deemed to have been enacted for an economic benefit
		235-17	Credit for qualified production costs incurred for a qualified motion picture, digital media, or film production

* Note: This exemption was reviewed in the report to the 2020 Legislature

Report Date	HRS Ref.	Statute to be reviewed	Notes
2027 Session	23-79	237-27.5	Gross proceeds from air pollution control facility construction, reconstruction, operation, use, maintenance, or furnishing
		238-3(k)	The value of air pollution control facilities
		237-27.6	Amounts received by solid waste processing, disposal, and electric generating facility operators under sale and leaseback transactions with political subdivisions that involve the facilities
		237-29	Gross income of qualified persons or firms or nonprofits or limited distribution mortgagors for certified or approved low-income housing projects
		238-3(j)	The value of property, services, or contracting exempted by section 237-29, relating to certified or approved housing projects
		431:7-208	Credit for low-income housing
		46-15.1(a)	Gross income from county low-income housing projects
		346-369	Compensation received by provider agencies for homeless services or homeless facility management
	23-93	235-7.3	Exclusion of royalties and other income derived from a patent, copyright, or trade secret of a qualified high technology business
		235-9.5	Exclusion for income and proceeds from stock options or stocks of a qualified high technology business or a holding company for a qualified high technology business
		235-17.5	Credit for capital infrastructure costs
		241-4.4	Credit for capital infrastructure costs
		235-110.7	Credit for capital goods used by a trade or business
		241-4.5	Credit for capital goods used by a trade or business
		235-110.91	Credit for research activity
		235-110.3	Credit for ethanol facility
		241-3.5	Deduction for adjusted eligible net income of an international banking facility

Report Date	HRS Ref.	Statute to be reviewed	Notes
2028 Session	23-80	237-29.5	Value or gross proceeds from tangible personal property shipped out of State
		237-29.53	Value or gross income from contracting or services performed for use outside the State
		238-1, paragraph (9)	Definition of “use”--The value of services or contracting imported for resale, consumption, or use outside the State
		237-29.55	Gross proceeds or gross income from the sale of tangible personal property imported into the State for subsequent resale
	23-94	235-4.5(a)	Exclusion of intangible income earned by a trust sited in this State
		235-4.5(b)	Exclusion of intangible income of a foreign corporation owned by a trust sited in this State
		235-4.5(c)	Credit to a resident beneficiary of a trust for income taxes paid by the trust to another state
		235-55	Credit for income taxes paid by a resident taxpayer to another jurisdiction
		235-129	Credit for income taxes paid by a resident taxpayer to another jurisdiction
		235-71(c)	Credit for a regulated investment company shareholder for the capital gains tax paid by the company
		235-110.6	Credit for fuel taxes paid by a commercial fisher
		235-110.93	Credit for important agricultural land qualified agricultural cost
		235-110.94	Credit for organically produced agricultural products
		235-129(b)	Credit to a shareholder of an S corporation for the shareholder’s pro rata share of the tax credit earned by the S corporation in this State
		209E-10	Credit for a qualified business in an enterprise zone; provided that the review of this credit pursuant to this part shall be limited in scope to income tax credits

Report Date	HRS Ref.	Statute to be reviewed	Notes
2029 Session	23-81	237-23(a)(3)	Fraternal benefit societies, orders, or associations for the payment of benefits to members
		237-23(a)(4)	Corporations, associations, trusts, or societies: (A) Organized and operated exclusively for religious, charitable, scientific, or educational purposes; (B) Operating senior citizens housing facilities qualifying for loans under the United States Housing Act of 1959, as amended; (C) Operating legal service plans; or (D) Operating or managing homeless facilities or other programs for the homeless
		237-23(a)(5)	Business leagues, chambers of commerce, boards of trade, civic leagues, agricultural and horticultural organizations, and organizations operated exclusively for the benefit of the community or promotion of social welfare, including legal service plans
		237-23(a)(6)	Hospitals, infirmaries, and sanitaria
		237-23(a)(7)	Tax-exempt potable water companies serving residential communities lacking access to public utility water services
		237-23(a)(8)	Agricultural cooperative associations incorporated under state or federal law
		237-23(a)(9)	Persons affected with Hansen's disease and kokuas with respect to business within the county of Kalawao
		237-23(a)(10)	Corporations, companies, associations, or trusts organized for cemeteries
		237-23(a)(11)	Nonprofit shippers
	23-95	235-15	Credit for purchase of child passenger restraint system
		235-55.6	Credit for employment-related expenses for household and dependent care services
		235-55.7	Credit for a low-income household renter
		235-55.85	Credit for food and excise tax

Report Date	HRS Ref.	Statute to be reviewed	Notes
2030 Session	23-72	237-3(b)	Gross receipts from the following: (A) Sales of securities; (B) Sales of commodity futures; (C) Sales of evidences of indebtedness; (D) Fee simple sales of improved or unimproved land; (E) Dividends; and (F) Sales or transfers of materials and supplies, interest on loans, and provision of services among members of an affiliated public service company group
		237-13(3)(B)	Gross income of contractors from subcontractors
		237-13(3)(C)	Reimbursements to federal cost-plus contractors
		237-13(6)(D)(i),(ii), (iii), and (iv)	Gross receipts of home service providers acting as service carriers
		237-24.3(11)	Amounts received from aircraft and aircraft engine rental or leasing
		237-24.9	Amounts received from aircraft servicing and maintenance and aircraft service and maintenance facility construction
		238-1, paragraph (6)	Definition of “use”--The value of aircraft leases or rental and acquired or imported aircrafts and aircraft engines
		238-1, paragraph (8)	Definition of “use”-- The value of material, parts, or tools for aircraft service and maintenance and aircraft service and maintenance facility construction

Appendix B

Impact on "Low-Income Residents"

Section 23-91, HRS, requires us to estimate the "annual cost of the exemption [or] exclusion... per low-income resident of the State." The statute defines "low-income resident" as a state resident who is: (1) the only member of a family of one and has an income of not more than 80 percent of the area median income for a family of one; or (2) part of a family with an income of not more than 80 percent of the area median income for a family of the same size. Applying this definition, there were an estimated 472,574 "low-income residents" statewide in 2019 based on data provided by the Department of Business, Economic Development and Tourism.

The results of this evaluation follow and only include costs for the tax provisions with reportable data.

Cost of Tax Credits per "Low-Income Resident"

Statute	Tax Provision	2019 Cost	Cost per "low-income resident"
Sections 235-110.7 and 241-4.5, HRS	Capital Goods Excise Tax Credit	$37.7 million	$79.78
Section 235-110.91, HRS	Tax Credit for Research Activities	$3.8 million	$8.04

Source: Office of the Auditor

The following table contrasts tax data with Hawai'i's total 2019 population of 1,415,872 people.

Cost of Tax Credits per Hawai'i Resident

Statute	Tax Provision	2019 Cost	Cost per Hawai'i resident
Sections 235-110.7 and 241-4.5, HRS	Capital Goods Excise Tax Credit	$37.7 million	$26.63
Section 235-110.91, HRS	Tax Credit for Research Activities	$3.8 million	$2.68

Source: Office of the Auditor

Department of Taxation’s Response to Draft Copy of Report

ON JUNE 16, 2022, we transmitted a draft of this report to the Department of Taxation. The Department of Taxation did not provide comments to this report.

A copy of the transmittal letter is included as Attachment 1.

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

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State Auditor

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June 16, 2022

VIA EMAIL ONLY (Tax.Directors.Office@hawaii.gov)

The Honorable Isaac W. Choy
Director, Department of Taxation
Princess Ruth Keʻelikōlani Building
830 Punchbowl Street, Room 221
Honolulu, Hawaiʻi 96813

Re: DRAFT copy of (1) *Review of Tax Provisions Pursuant to Section 23-74, Hawaiʻi Revised Statutes* and (2) *Review of Income and Financial Institutions Tax Provisions Pursuant to Section 23-93, Hawaiʻi Revised Statutes*

Dear Director Choy:

Attached for your review are draft copies of the Auditor's:

1. *Review of Tax Provisions Pursuant to Section 23-74, Hawaiʻi Revised Statutes*; and

2. *Review of Income and Financial Institutions Tax Provisions Pursuant to Section 23-93, Hawaiʻi Revised Statutes*.

We wanted to thank you and your staff for your assistance as we prepared these reports.

Please let us know by **June 22, 2022** whether your department plans to provide comments on one or both of the draft reports. If you do wish to submit comments, we ask that you please provide them to us by **June 30, 2022**. We would appreciate separate comments for each report.

As these are draft reports, we request that these reports be kept confidential within your department. Also, if you or your staff would like to schedule a meeting (virtual or in person) to discuss the drafts, please let us know by **June 22, 2022**. If so, we will be glad to set something up.

If you have any questions, please feel free to contact project supervisor Chuck Narikiyo via email at chuck.narikiyo@hawaii.gov.

Thank you for your consideration.

Very truly yours,

Leslie H. Kondo
State Auditor

CTN:SLH:emo
Attachments
cc/attach: Seth S. Colby, Tax Research and Planning Officer (Seth.S.Colby@hawaii.gov)
Ted Shiraishi, Rules Officer (ted.s.shiraishi@hawaii.gov)