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SENATE COMMITTEE ON ECONOMIC DEVELOPMENT, TOURISM, AND TECHNOLOGY
The Honorable Glenn Wakai, Chair
The Honorable Brian T. Taniguchi, Vice Chair

SENATE COMMITTEE ON HIGHER EDUCATION
The Honorable Kaialiʻi Kahele, Chair
The Honorable Michelle N. Kidani, Vice Chair

S.B. No. 1191, Relating to Film and Digital Media Industry Development

Hearing: Friday, February 10, 2017, 1:25 p.m.

The Office of the Auditor has **no position** regarding S.B. No. 1191, Relating to Film and Digital Media Industry Development, which will extend the motion picture, digital media, and film production tax credit (the "film tax credit") for an additional 10 years and amends the financial or in-kind contributions to workforce development efforts required to qualify for the tax credit. We recently completed an audit of the film tax credit, Report No. 16-08, *Audit of Hawaiʻi's Motion Picture, Digital Media, and Film Production Tax Credit* (November 2016), and offer testimony to advise the committee as to certain findings that may be relevant to its consideration of the bill.

With respect to the current requirement that productions make financial or in-kind contributions to qualify for the film tax credit, we examined the department of taxation's *proposed* administrative rules, which were issued in 2009 and, at the time of our review, the Hawaiʻi film office was using to administer the tax credit. Those rules defined the monetary amount of the financial or in-kind contribution required to qualify for the tax credit: "at a minimum, equal to *the lesser of* 0.1 percent of a production's qualified production costs or $1,000."

We reported that a production with $1 million in qualified production costs incurred on a neighbor island was entitled to receive a film tax credit of $250,000. Yet, that production could satisfy the requirement by making a monetary contribution of only $1,000, which is only 0.4 percent of its tax credit. A production that receives $15 million in film tax credits can similarly satisfy the requirement by making a $1,000 contribution to a Hawaiʻi public school.

We suggested that, when compared to the amount of the film tax credit awarded, the state was not receiving sufficient benefit; that is, the financial contribution and workforce development requirements seemed unlikely to help meaningfully grow the local film industry. We recommended that the department of taxation promulgate administrative rules that, among other things, require productions to make a more meaningful financial or in-kind contribution.

We note that, subsequent to our audit report, the department of taxation promulgated *temporary* administrative rules, which require a production's financial or in-kind contribution to be "at least the equivalent value of 0.1 per cent of a production's qualified production costs or $1,000, *whichever is higher*."

We have attached the Auditor's Summary of the audit. The complete report is available on our website, at http://auditor.hawaii.gov/.

Thank you for considering our testimony related to S.B. No. 1191.

Auditor's Summary

Audit of Hawai‘i's Motion Picture, Digital Media, and Film Production Income Tax Credit

Report No. 16-08

Photo: Petty Officer 2nd Class Nardel Gervacio - Public Domain, https://commons.wikimedia.org/w/index.php?curid=39383018

What problems did the audit work identify?

IN REPORT NO. 16-08, *Audit of Hawai‘i's Motion Picture, Digital Media, and Film Production Income Tax Credit*, we found that insufficient administration of the film tax credit by the Department of Taxation (DoTAX) and the Hawai‘i Film Office has likely increased the cost of the credit while overstating the possible economic benefits that it provides to the State.

Why did these problems occur?

DOTAX HAS BROADENED THE SCOPE of the film tax credit by including out-of-state expenses as "qualified production costs." That action is inconsistent with the plain language of the statute and the Legislature's intent that the incentive would stimulate economic growth in Hawai‘i. For example, expenditures paid to out-of-state businesses and service providers do not infuse money into Hawai‘i's economy or provide income for local residents; they do not create local jobs.

We also found that DoTAX has not adopted administrative rules needed to provide assurance that the film tax credits are sufficiently administered. Without such rules, tax credit qualifications are unclear, the film office

Tax credits: tools for economic development

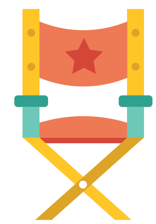
TAX CREDITS and other forms of financial incentives are forms of government spending. Tax credits reduce the amount of tax that a business otherwise would be required to pay. In the case of refundable tax credits, if the amount of a tax credit exceeds a taxpayer's tax liability, the excess of the credit over the liability can be paid by the government to the taxpayer in the form of a tax refund.

does not have the administrative tools to enforce deadlines and other filing requirements, and there is no requirement that production costs be independently verified as qualifying for the tax credit. We have serious concerns about DoTAX's extended delay in promulgating rules. It has been more than ten years since the current form of the film tax credit was enacted.

Although the film tax credit law has existed in its current form since 2006, DoTAX has yet to promulgate rules.

While we strongly recommend that DoTAX promulgate rules without further delay, we found a number of provisions in the most recent public version of the proposed rules that should be revised to provide greater assurance that the film tax credits are being managed in accordance and consistent with the statute's intent.

We also found that the film office's analysis of film tax credit data does not measure the incentive's true costs and reports economic impacts that are based on incomplete and overstated data. For instance, it includes an unknown amount of out-of-state expenditures and wages paid to non-residents, as well as inaccurate production expenditure data. For example, highly paid producers, directors, actors, and crew are often residents of other states. While they may spend some of their salary or wages in Hawai‘i, it is very unlikely that a significant percentage of their Hawai‘i-earned income flows into the local economy. Including these salaries and other out-of-state expenditures in the calculation of benefits to the State significantly over-inflates the film tax credit's economic impacts. Instead, the film office should report to the Legislature on the quality of the jobs generated by film productions. Currently, the film office collects this type of information from production companies applying for the tax credit, but it does not track or report on it.



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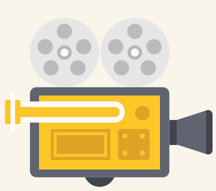
The percentages of qualified production costs a company receives as a tax credit for filming on O‘ahu (20 percent or a neighbor island (25 percent

Why do these problems matter?

THE FILM TAX CREDIT is set to sunset at the end of 2018, at which time the Legislature will need to decide whether the benefits of the program justify its continuing costs. Unfortunately, the film office cannot provide the Legislature with the relevant, accurate, and timely data necessary to make this determination.



Starring Roles

We found that, for a major motion picture shot in 2014, above-the-line talent earned $3.36 million in wages while filming in Hawai‘i. All of these jobs were filled by non-Hawai‘i residents. Based on the Department of Business, Economic Development and Tourism's economic model, the film office likely estimated that the $3.36 million earned by the non-resident talent generated more than $1.41 million in local household income, even though the majority of the above-the-line talents' earnings likely were spent outside of Hawai‘i.