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DEPT. COMM. NO. 131

December 13, 2023

VIA EMAIL

The Honorable Ronald D. Kouchi
Senate President
415 South Beretania Street
Hawaiʻi State Capitol, Room 409
Honolulu, Hawaiʻi 96813

VIA EMAIL

The Honorable Scott K. Saiki
Speaker, House of Representatives
415 South Beretania Street
Hawaiʻi State Capitol, Room 431
Honolulu, Hawaiʻi 96813

Re: *Review of Income Tax Provisions Pursuant to Section 23-94, Hawaiʻi Revised Statutes*, Report No. 23-15

Dear President Kouchi and Speaker Saiki:

Please find attached Report No. 23-15, *Review of Income Tax Provisions Pursuant to Section 23-94, Hawaiʻi Revised Statutes*, along with a copy of the Auditor's Summary. The audit was performed pursuant to Section 23-91 et seq., Hawaiʻi Revised Statutes, and is a report on certain tax exclusions and credits.

The report is accessible through our website at:
https://files.hawaii.gov/auditor/Reports/2023/23-15.pdf.

The summary is also accessible through our website at:
https://files.hawaii.gov/auditor/Overviews/2023/23-15AuditorSummary.pdf

If you have any questions about the report, please contact me.

Very truly yours,

Leslie H. Kondo
State Auditor

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Attachments
ec/attach: Members of the Senate
Members of the House of Representatives
Carol Taniguchi, Senate Chief Clerk
Brian Takeshita, House Chief Clerk

Auditor's Summary

Review of Income Tax Provisions Pursuant to Section 23-94, Hawai‘i Revised Statutes

Report No. 23-15

ILLUSTRATION: ISTOCK.COM

THIS REPORT ASSESSES eight credits and two exclusions allowable under Hawai‘i's Income Tax laws. Section 23-91 et seq., Hawai‘i Revised Statutes (HRS), requires the Auditor to review income tax provisions annually, on a five-year recurring cycle.

Specifically, this report reviews the following tax provisions:

- Exclusion of intangible income of trusts with nonresident beneficiaries, Section 235-4.5(a), HRS;
- Exclusion of intangible income of foreign corporations owned by such trusts, Section 235-4.5(b), HRS;
- Credit for taxes paid to another jurisdiction by trusts, Section 235-4.5(c), HRS;
- Credit for taxes paid to another jurisdiction by S corporations, Section 235-129(a), HRS;
- Credit to S corporation shareholders for credits earned by S corporations, Section 235-129(b), HRS;
- Credit for taxes paid to another jurisdiction by individuals, Section 235-55, HRS;
- Credit to shareholders for taxes on undistributed capital gains of regulated investment companies, Section 235-71(c), HRS;

This review informs the public and policymakers of the purposes, costs, and benefits of ten Hawai‘i income tax incentives, and includes recommendations to address issues arising from the incentives and their usage.

- Credit for commercial fisher fuel taxes, Section 235-110.6, HRS;
- Credit for costs of maintaining Important Agricultural Lands, Section 235-110.93, HRS; and
- Credit for qualified businesses in Enterprise Zones, Section 209E-10, HRS.

We determined that six provisions accomplish their purposes and one does not, but were unable to determine whether three other provisions achieved the primary purposes for which they were adopted. The inability to draw conclusions with respect to those three provisions stemmed primarily from a lack of data regarding their utilization. Determining whether purposes have been met was also frustrated by a lack of claim tracking or statutorily identified benchmarks or metrics. With respect to some provisions, it was difficult to determine what outcomes the Legislature intended to achieve, as there is no clear indication from underlying bills or their legislative histories.

We recommend that other state agencies be tasked with performing cost-benefit analyses of the commercial fisher fuel tax credit (Section 235-110.6, HRS) and the Enterprise Zone credit (Section 209E-10, 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 other resources necessary to conduct a thorough cost-benefit analysis of either credit.

Link to the complete report:

Review of Income Tax Provisions Pursuant to Section 23-94, Hawai‘i Revised Statutes

https://files.hawaii.gov/auditor/Reports/2023/23-15.pdf

Review of Income Tax Provisions Pursuant to Section 23-94, Hawaiʻi Revised Statutes

A Report to the Legislature
and the Governor of the
State of Hawaiʻi

Report No. 23-15
December 2023

OFFICE OF THE AUDITOR
STATE OF HAWAIʻI

OFFICE OF THE AUDITOR
STATE OF HAWAI‘I

Constitutional Mandate

Pursuant to Article VII, Section 10 of the Hawai‘i State Constitution, the Office of the Auditor shall conduct post-audits of the transactions, accounts, programs and performance of all departments, offices and agencies of the State and its political subdivisions.

The Auditor’s position was established to help eliminate waste and inefficiency in government, provide the Legislature with a check against the powers of the executive branch, and ensure that public funds are expended according to legislative intent.

Hawai‘i Revised Statutes, Chapter 23, gives the Auditor broad powers to examine all books, records, files, papers and documents, and financial affairs of every agency. The Auditor also has the authority to summon people to produce records and answer questions under oath.

Our Mission

To improve government through independent and objective analyses.

We provide independent, objective, and meaningful answers to questions about government performance. Our aim is to hold agencies accountable for their policy implementation, program management, and expenditure of public funds.

Our Work

We conduct performance audits (also called management or operations audits), which examine the efficiency and effectiveness of government programs or agencies, as well as financial audits, which attest to the fairness of financial statements of the State and its agencies.

Additionally, we perform procurement audits, sunrise analyses and sunset evaluations of proposed regulatory programs, analyses of proposals to mandate health insurance benefits, analyses of proposed special and revolving funds, analyses of existing special, revolving and trust funds, and special studies requested by the Legislature.

We report our findings and make recommendations to the governor and the Legislature to help them make informed decisions.

For more information on the Office of the Auditor, visit our website:
https://auditor.hawaii.gov

Foreword

This report assesses tax credits and exclusions under Hawai‘i’s Income 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; Public Utilities Commission; and the Department of Commerce and Consumer Affairs for their assistance in providing data and other information for this report.

Leslie H. Kondo
State Auditor

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ILLUSTRATION: ISTOCK.COM

Review of Income Tax Provisions Pursuant to Section 23-94, Hawai‘i Revised Statutes

Introduction

THIS REPORT assesses a variety of tax incentives allowed under the law relating to Hawai‘i's Income Tax. Section 23-91 et seq., Hawai‘i Revised Statutes (HRS), requires the Auditor to review specific tax provisions on a five-year recurring cycle. For 2022 and every five years thereafter, Section 23-94, HRS, requires the review of the following incentives:

- Exclusions of intangible income to trusts with nonresident beneficiaries (Sections 235-4.5(a) and (b), HRS);
- Credit for taxes paid to another jurisdiction (Sections 235-55, 235-129(a), and 235-4.5(c), HRS);
- Credit to an S corporation shareholder as a pass-through S corporation benefit (Section 235-129(b), HRS);
- Credit to offset regulated investment company capital gains taxes (Section 235-71(c), HRS);
- Credit for commercial fishers to offset fuel taxes (Section 235-110.6, HRS);

This review informs the public and policymakers of the purposes, costs, and benefits of ten Hawai‘i income tax incentives, and includes recommendations to address issues arising from the incentives and their usage.

- Credit for maintaining Important Agricultural Lands (Section 235-110.93, HRS); and
- Credit for businesses in Enterprise Zones[1] (Section 209E-10, HRS).

This report addresses incentives concerning the above topics only. A complete list of tax provisions to be reviewed, for all years, is included in Appendix A.

Background

Chapter 235, HRS, is Hawai‘i's income tax law. Tax credits are amounts subtracted directly from a taxpayer's tax liability, reducing the amount of taxes due on a dollar-for-dollar basis. Exemptions are items of gross income not subject to taxation, reported on a tax return as non-taxable. Exclusions are income amounts not considered gross income for taxation purposes, usually not reported at all.

Lawmakers often choose to provide relief from taxation to promote social and economic goals, or for tax efficiency or equity purposes. Act 261, Session Laws of Hawai‘i (SLH) 2016, which established the annual review of income tax provisions by the Auditor, noted that such provisions reduce revenue to the State. That results in all taxpayers, including those who do not directly benefit from the credits, exclusions, and exemptions, having to compensate for the reduced revenue or, alternatively, funding for state programs must be curtailed. However, the Legislature also believed that some of these tax cutting provisions are worthy of continuation for equity, efficiency, and economic and social policy purposes.

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.

Section 23-94, HRS, requires review of the abovementioned tax provisions. The exclusions for intangible income earned by a Hawai‘i trust with nonresident beneficiaries (Section 235-4.5(a), HRS) and for intangible income of a foreign corporation owned by such a trust (Section 235-4.5(b), HRS) were reviewed together. Likewise, the tax credits for a resident beneficiary of a trust for income taxes paid by the trust to another state (Section 235-4.5(c), HRS), for income taxes paid

[1] Per Section 23-94(c)(10), HRS, the review of the Enterprise Zones credit is limited to the income tax credit component of the Enterprise Zone program.

by a resident taxpayer to another jurisdiction (Section 235-55, HRS), and for income taxes paid by an S corporation to another jurisdiction (Section 235-129(a), HRS) were evaluated together, as they are all intended to eliminate double taxation of income and because claims are filed and tracked by the Department of Taxation (DOTAX) in a commingled fashion.

Under Section 23-94, HRS, this report also was to include a review of the credit for organically produced agricultural products provided under Section 235-110.94, HRS, however, that tax provision has since been repealed. For that reason, we did not review that tax credit.

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 acts 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 tax credit for fuel taxes paid by a commercial fisher (Section 235-110.6, HRS) and the income tax credit for a qualified business in an Enterprise Zone (Section 209E-10, 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 tax credits.

Hawai‘i Taxes

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 are low in comparison to other states. In FY2022, the State General Fund, which is the chief operating fund of the State, realized a total of $8.74 billion in tax revenue. Most of that revenue came from two taxes: net income tax and General Excise Tax (GET). Net income tax collections, which include both individual and corporate income tax revenues, represent Hawai‘i's largest tax revenue source and accounted for $3.76 billion. GET, the second largest tax revenue source, accounted for $3.60 billion, or 41 percent of total General Fund tax revenue. The Transient Accommodations Tax, the State's third-largest revenue source, accounted for $661 million.

Hawai‘i Tax Credits

Hawai‘i's first tax credit was established in 1957. Some of the State's tax credits were instituted to promote social goals such as child safety, while others are meant to promote selected industries or economic activities; some are meant to prevent double taxation of income. That last category includes tax provisions reviewed in this report that provide a credit for income taxes paid to another jurisdiction.

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 tax liability in a particular year, the unused portion of nonrefundable credits generally can be carried forward and applied to the filer's future years' taxes. In contrast, a taxpayer is ensured it will receive the full amount of a refundable tax credit in the year the credit is claimed; if the tax credit exceeds tax liability, the taxpayer receives a payment – a tax refund – from the State for the difference. The commercial fisher fuel tax credit (Section 235-110.6, HRS), reviewed in this report, is an example of a refundable credit.

In total, there were 22 active Hawai‘i tax credits in 2020, according to DOTAX's *Tax Credits Claimed by Hawai‘i Taxpayers Tax Year 2020* report.[2] Overall, $370.2 million in tax credits were claimed in 2020, up from $300.6 million the prior year, largely due to increased renewable energy technologies income tax credit claims. The largest amount claimed, $181.1 million, was for tax credits aimed at encouraging certain industries or economic activities; followed by $99.7 million claimed for tax credits meant to avoid double taxation; and $89.4 million claimed for tax credits to promote social welfare. Credit distribution for 2020 was as depicted in the following chart.

In addition to tax credits, tax breaks reviewed in this report occurred in the form of exclusions. Exclusions remove from taxation revenues that, according to DOTAX, were never intended to be part of a broadly defined tax base. Excluded amounts generally are not included in a taxpayer's reported revenues.

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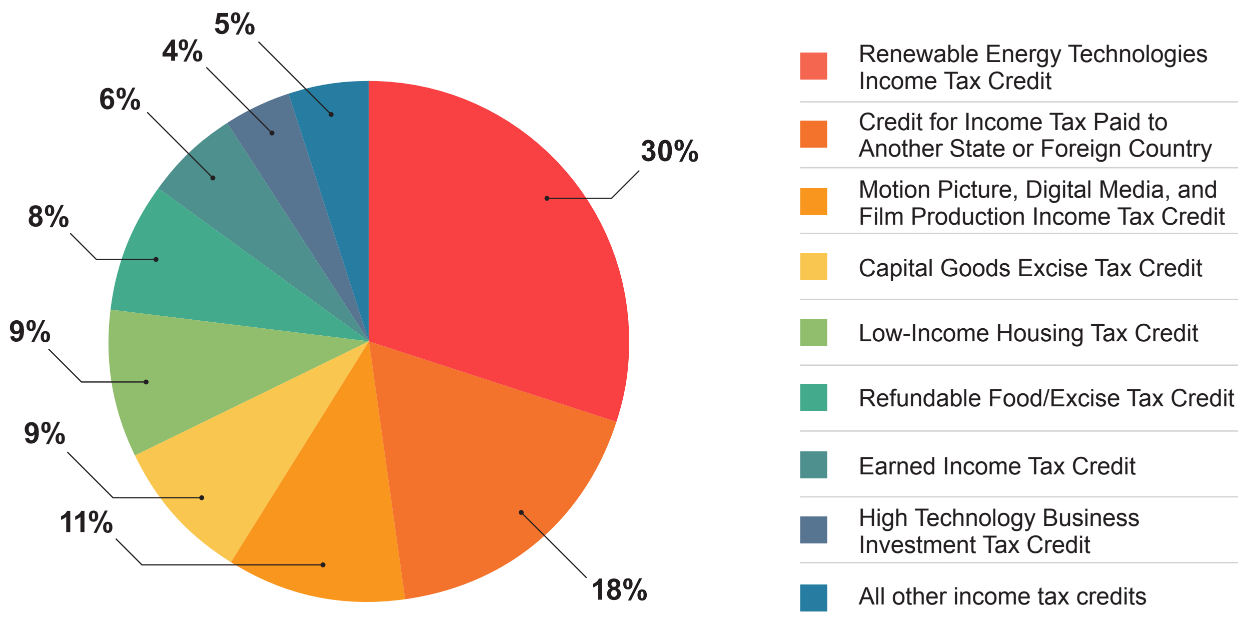
[2] Throughout this report, our office uses data from the 2020 DOTAX report entitled *Tax Credits Claimed by Hawai‘i Taxpayers Tax Year 2020* and from similar DOTAX tax credit reports from earlier years. At a late stage in the completing of this report, in September of 2023, DOTAX published a tax credit report for 2021, entitled *Tax Credits Claimed by Hawai‘i Taxpayers Tax Year 2021*. The 2021 tax credit data arrived too late to be used as a basis for this report, but the data will be used in our next similar report.

Tax Credits by Dollar Amount Claimed



Source: DOTAX

Tax Expenditures: At What "Cost"?

IN TOTAL, the tax credits reviewed in this report resulted in $67.2 million in claims in 2020 but, according to DOTAX, just $1.1 million in tax expenditures.

Identifying whether income tax relief provided by the State is considered a tax expenditure can be complicated. It includes determining whether the tax relief provided involves income that should be subject to taxation. Another factor to consider is whether the tax relief that is provided costs taxpayers money. For example, the tax credit provided in Section 235-4.5(c), HRS, which we review in this report, provides an income tax credit to a Hawai'i taxpayer beneficiary of an out-of-state trust for income taxes paid by the trust to another state. In that instance, the issue is not whether the tax is paid, but rather where the tax is paid – the state where the trust is located or the state where the shareholder lives. Because such tax credits are meant to avoid the taxation of the same economic activity twice by different tax authorities, or by tax authorities in two different tax jurisdictions, they generally are not considered to be tax expenditures. A Hawai'i taxpayer is taxed on worldwide income, such that, if any of that income is subject to taxation by another state, then the U.S. Constitution requires Hawai'i to offset its tax by that imposed by the other state – whether through a credit or otherwise. In such an instance, according to DOTAX, there is no tax expenditure because Hawai'i is incapable of collecting such a tax, even if it wanted to.

In contrast, in the case of the tax credit for a qualified business in an Enterprise Zone in Section 209E-10, HRS, there is no double taxation issue. Rather, in an effort to stimulate business and industrial growth, the State reimburses taxpayers for engaging in a certain activity that otherwise would be subject to Hawai'i income tax. In that case, the amount of tax relief provided is considered a tax expenditure.

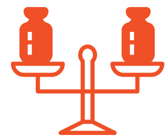
Tax Equity and Efficiency: Finding the Balance

WE ARE REQUIRED to assess whether the tax provisions reviewed are necessary to promote or preserve tax equity or efficiency as part of our review; 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 taxpayers fairly, which means, among other things, that similar taxpayers be taxed similarly while taxpayers with the greatest ability to pay have the highest tax burdens. 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 payment ability pay more.

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, tax rules favoring a particular industry or investment can result in harm to other industries or investments, as well as to the economy as a whole. Lawmakers must carefully balance both principles to optimize tax policy.

Section 23-91, HRS, requires the Auditor to determine not only whether reviewed tax provisions promote tax equity or efficiency, but also whether they are “necessary to promote or preserve tax equity or efficiency.” That mandate implies a need to analyze each provision within Hawai‘i’s current social, economic, and budgetary contexts.



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

Analysis of Reviewed Tax Provisions

What did we review?

This report reviews a total of ten Hawai‘i income tax provisions, which include eight credits and two exclusions. Our analysis included reviewing confidential DOTAX taxpayer records under authority provided by Section 231-3.3, HRS, which was adopted under Act 177, SLH 2017. That section requires any information identified by DOTAX as confidential to be kept confidential by the Auditor.

What did we find?

We determined that six provisions accomplish their purposes and one does not, but were unable to determine whether three other provisions achieved the main purposes for which they were adopted. The inability to make a determination with respect to the latter three provisions stemmed primarily from a lack of data regarding their utilization. Concluding as to whether purposes have been met has been frustrated by a lack of claim tracking and lack of benchmarks or metrics statutorily set forth to assess whether a provision is achieving its intended purpose. Table 1 below summarizes these results.

Table 1. Summary of Results

HRS Section(s)	Incentive Type	Subject Matter Covered	Achieves Purpose?	Recommendation
235-4.5(a)*	Exclusion	Intangible income of trusts with nonresident beneficiaries	Yes	Retain
235-4.5(b)*	Exclusion	Intangible income of trust-owned foreign corporations	Yes	Retain
235-4.5(c)**	Credit	Taxes paid to another jurisdiction – trusts	Yes	Retain
235-129(a)**	Credit (read with 235-55)	Taxes paid to another jurisdiction – S corporations	Yes	Retain
235-129(b)**	Credit	Credit passthrough – S corporations	No	Retain
235-55**	Credit	Taxes paid to another jurisdiction – Individuals	Yes	Modify
235-71(c)	Credit	Regulated investment company capital gains tax	Yes	Retain
235-110.6	Credit	Commercial fishing fuel tax	Unable to Determine	Repeal
235-110.93	Credit	Important Agricultural Lands	Unable to Determine	Unable to Determine
209E-10	Credit	Enterprise Zones	Unable to Determine	Unable to Determine

Source: Office of the Auditor

*Note: We analyzed these exclusions as though they were one exclusion, as both concern intangible income either directly or indirectly from a Hawai‘i trust.

**Note: We analyzed these tax credits as though they were one credit, as DOTAX tracks these as one credit.

Assessment Challenges: Lack of Data on Cost, Causation

Many challenges hindered our ability to report information and analyze income tax exclusions and credits in the manner required under Section 23-91, HRS, including a lack of available data. While the DOTAX Tax System Modernization project has improved data collection, DOTAX currently does not capture additional specific information we need to more meaningfully assess the exclusions and credits. For some provisions, the lack of historical data precluded us from determining "the amount of tax expenditure for the credit, exclusion, or deduction for each of the previous three calendar years," as required by Section 23-91, HRS. The absence of historical data also hindered our ability to estimate the amounts of tax expenditures for the current and next two calendar years. Without that data and the specialized training, knowledge, and tools to forecast economic trends, we determined any projection on the future cost of exemptions and credits would be too speculative and unreliable to be included in this report.

We were further challenged to determine whether the purpose of or intent behind some tax credits, exclusions, and deductions had been achieved. When the purpose of a tax provision was not explicitly stated within legislation, we used other sources, such as committee reports and other legislative history, to infer purpose. Occasionally, however, we were unable to assess whether a particular tax provision is meeting its purpose because none of the provisions include specific benchmarks or other criteria against which effectiveness of the provisions may be measured. The legislative acts that created the credits and exclusions lacked benchmarks, targets, and desired outcomes that could be used to measure achievement of the intended purpose.

In addition, an analysis of economic or employment benefits compared against forgone tax revenue, or cost-benefit analysis, was hampered by a variety of other factors. Businesses that benefit from these credits and exclusions are required to provide to DOTAX, at most, amounts claimed. We were also unable to share taxpayer names or other confidential tax return data with other relevant state agencies to identify claimants independently and to verify employment and payroll data for taxpayers claiming incentives that may be intended to stimulate local employment. Taxpayers do not report to DOTAX data on jobs, wages, or other economic activities that may have been generated because of a tax provision.

Further, our analysis could not account for a variety of unintended effects. For example, some businesses that claimed a tax credit aimed at generating economic activity may have received tax benefits for jobs that would have been created irrespective of the tax preference, 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 preference. 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.

Finally, we conducted an analysis of the impact of the 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 provision would have for low-income residents. Although money generated from repealing a particular exemption, credit, or exclusion likely will increase tax revenues, the impact of the additional funds will not confer a benefit upon low-income residents in particular, but to all residents. Further discussion, as well as our calculations, can be found in Appendix B.

An additional concern is that the term "tax expenditure" is not defined in Hawai‘i's tax laws or in Section 23-91, HRS, which mandates this review. See "Tax Expenditures: At What 'Cost'?" on page 5.

Income Tax Exclusions For Nonresidents' Intangible Income Realized Through a Hawai‘i Trust (Sections 235-4.5(a) and (b), HRS)

THESE PROVISIONS exclude from Hawai‘i income tax intangible income realized by a Hawai‘i trust to the extent the beneficiaries of that trust are non-residents of Hawai‘i. Intangible income, in this context, refers to passive income, such as dividends and interest. Essentially, if the beneficiaries of a Hawai‘i trust are nonresidents, then Hawai‘i will not tax the trust – at least to the extent the trust is simply an investment vehicle not engaging in any active business involving Hawai‘i. Subsection (a) of the provision excludes the income for the trust and its beneficiaries. Subsection (b) extends the exclusion to any non-U.S. holding corporation wholly owned by such a trust.

The exclusions effectively prevent double taxation. In light of the exclusions, for each beneficiary, only one state – that beneficiary's resident state – should be able to tax intangible income flowing from the Hawai‘i trust. If there were no exclusion, then, absent any other relief, Hawai‘i and the beneficiary's resident state could both tax the same income. The provision conforms with the constitutional prohibition against double taxation, and with the related income sourcing principle that income from non-physical assets, if not used as capital or controlled elsewhere, should be sourced to a taxpayer's state of residence – regardless of where the income was generated.

Exclusions at a Glance (2020)

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	Yes

Relevant Legislative History

Section 235-4.5(a) and (b), HRS

1985

Act 283, SLH 1985, created Section 235-4.5(a), HRS

1988

Act 33, SLH 1988, created Section 235-4.5(b), HRS

How do the exclusions work?

A taxpayer claims the exclusion by not reporting, and thereby not paying tax on, income covered by the statute. Intangible income to the trust is simply left off the relevant tax return, completely. The relevant Hawai‘i rules of trust taxation follow federal rules, which distinguish between two types of trust: grantor trusts and non-grantor trusts. Whether the trust is grantor or non-grantor determines who must declare and pay tax on trust income, and therefore affects who may benefit from the exclusion. Depending on trust type, the income could be excluded from an individual return, a trust return, a corporate return, or a combination of multiple returns, and thus an individual, the trust itself, or a trust-owned corporation, or a combination, could benefit from the exclusion. That, in turn, affects the State's tax expenditure, as individuals, trusts, and corporations are taxed at different rates. In other words, the tax that the State forgoes can vary in amount depending on who is the taxpayer.

We note that our position on tax expenditure differs from that of DOTAX. DOTAX takes the position that an exclusion does not represent or trigger a tax expenditure because an exclusion relates to income that was never intended to be taxed. We respectfully disagree with that approach in the context of income tax. Under Hawai‘i law, but for a codified exclusion or other legislated tax relief, all income (of a resident[3]), regardless of its source – meaning from anywhere in the world – should be taxable. In other words, but for the expressly specified relief, the State would indeed receive additional tax. Excluding the underlying income precludes the generation of associated tax revenue and thus signifies a tax expenditure.

Returning more pointedly to the exclusion under review, any taxpayer who would owe tax on trust income may, to the extent the beneficiaries are nonresidents, ignore intangible income. In the case of a non-grantor trust, where the trust itself would normally pay tax, the trust may exclude the intangible income. In the case of a grantor trust, where the grantor – or a beneficiary, if not the grantor – would normally pay the tax, that grantor or beneficiary may exclude the income. This can be best understood by way of two examples below: one involving a grantor trust and one involving a non-grantor trust.

Grantor Trust Example[4]
Individual Grantor Benefits from the Exclusion

Hawai‘i resident John Smith has his attorney draft The John Smith Trust, a Hawai‘i trust which, under its own terms, John may revoke at any time. John places into the trust various stocks and bonds. The trust document states that all trust income will go to John until his death – at which time the entire trust will go to a third party not relevant for the rest of this example. During John’s lifetime, John is both the grantor and sole beneficiary of the trust, and the trust is a grantor trust because it is revocable. As a grantor trust, the trust is disregarded for income tax purposes and does not pay income tax. Instead, it is John who declares and pays tax – at his personal rate – on income generated by the trust.

Applying the Exclusion: Two years later, John permanently moves to Oregon, changing his tax residence from Hawai‘i to Oregon. Now that the sole beneficiary, John, is a Hawai‘i nonresident, all

[3] Special rules apply to nonresidents of the State. Such rules, except where specifically discussed later in this report, are beyond the scope of this report.

[4] All examples in this report are fictional, simplified, and illustrative.

intangible income of the trust – all the stock dividends and bond interest – should be excluded from Hawai‘i tax under Section 235-4.5(a), HRS. John may need to pay tax to his resident state of Oregon, but that should be the only state to which he pays tax with respect to intangible income from the trust. As far as Hawai‘i is concerned, John need no longer declare or pay tax on such income. <u>John Smith personally benefits because, absent the exclusion, he would have had to pay the Hawai‘i tax personally.</u>

The Tax Expenditure: As detailed above, without the exclusion, John would pay Hawai‘i tax on the dividends and interest. Dividends and interest are income, John is a resident, and under the general rule, residents are taxed on all their income, worldwide. The provision we now review carves this specific income out of what is taxable, and the tax expenditure to Hawai‘i is the Hawai‘i income tax that John legally avoids. <u>That figure will depend on a variety of factors, notably including John's individual rate of tax, as based on his filing status and taxable income from other sources.</u>

Non-Grantor Trust Example
Trust Benefits from the Exclusion

Hawai‘i resident Mary Smith has her attorney draft the Mary-to-Dana Trust, a Hawai‘i trust that, under its own terms, Mary may never revoke. Mary places into the trust various stocks and bonds, hiring a trustee to manage the assets and otherwise control the trust. The trust document states that all income from the trust will go to Mary's daughter, Hawai‘i resident Dana, until Mary's death – at which time the entire trust will terminate, with full liquidation of all assets to the benefit of Dana. During Mary's lifetime, the trust is a non-grantor trust because it is irrevocable and does not trigger any rule that would cause Mary or Dana to be deemed an owner of the trust. Mary does not receive, declare, or pay tax on any income generated by the trust. Instead, the Mary-to-Dana Trust files its own trust tax return, paying Hawai‘i tax on its income at trust tax rates.

Applying the Exclusion: Two years later, Dana moves to California, changing her tax residence from Hawai‘i to California. Now that the sole beneficiary of the trust is a Hawai‘i nonresident, all the stock dividends and bond interest – the intangible income of the trust – should be excluded from Hawai‘i income tax under Section 235-4.5(a), HRS. The trust should not need to pay tax to Hawai‘i, nor issue a Schedule K-1 showing Hawai‘i income to its beneficiary, Dana. Dana may need to pay tax to her resident state of California, but that should be the only state to which she should pay tax with respect to intangible income from the trust. Thus, double taxation is prevented. As far as Hawai‘i is concerned, the trust no longer needs to declare or pay tax on such income, which means such income should not appear on its own return or on the Hawai‘i return of its beneficiary, Dana. In this example, the Mary-to-Dana Trust benefits directly from the credit, and Dana benefits indirectly. Absent the exclusion, and absent any special deductions taken by the trust[5], the trust would have had to pay the Hawai‘i tax – at trust tax rates.

The Tax Expenditure: As detailed above, were the exclusion not in place, the Mary-to-Dana Trust would pay tax on the dividends and interest.[6] The analysis is the same as in the previous example, except that the taxpayer initially avoiding tax is the trust, not any individual. Hence, in this example, the tax expenditure to the State is whatever tax payment the trust has avoided. That figure will vary depending on what taxable income the trust may have from other sources.

What is the purpose of the exclusions?

According to Senate Committee reports on the bill that became Act 283, SLH 1985, the purposes of the two reviewed subsections of Section 235-4.5, subsections (a) and (b), HRS, were as follows:

Section 235-4.5(a), HRS: The primary purpose of this subsection is to prevent double taxation, in this context meaning taxation by two states on the same intangible income realized by any trust that has nonresident beneficiaries. Prior to the exclusion, the rule in Hawai‘i was to tax such income regardless of a beneficiary’s residence. That meant a nonresident beneficiary of a Hawai‘i trust could be taxed by both the beneficiary’s resident state and Hawai‘i. One legislative committee expressed a concern that Hawai‘i trusts with nonresident beneficiaries would choose to leave Hawai‘i for states that did not tax nonresidents on such income. The committee further was concerned that such an incentive to leave Hawai‘i put the state at a disadvantage at attracting trusts from foreign sources. In short, the purpose of the exclusion for nonresidents is to remove a disadvantage – to make Hawai‘i tax-competitive as a place to create a trust.

Section 235-4.5(b), HRS: The primary purpose of this subsection is to encourage the development of Hawai‘i as an international center of financial services. The Legislature noted that a corporation may act as a personal holding company, which we note is a common tax planning strategy for foreigners and tax-exempt investors wanting to

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[5] This example is illustrative only. Whether the trust or Dana ultimately would have had to pay the tax, absent an exclusion, would depend on whether and to what extent the trust deducted distributions paid to Dana.

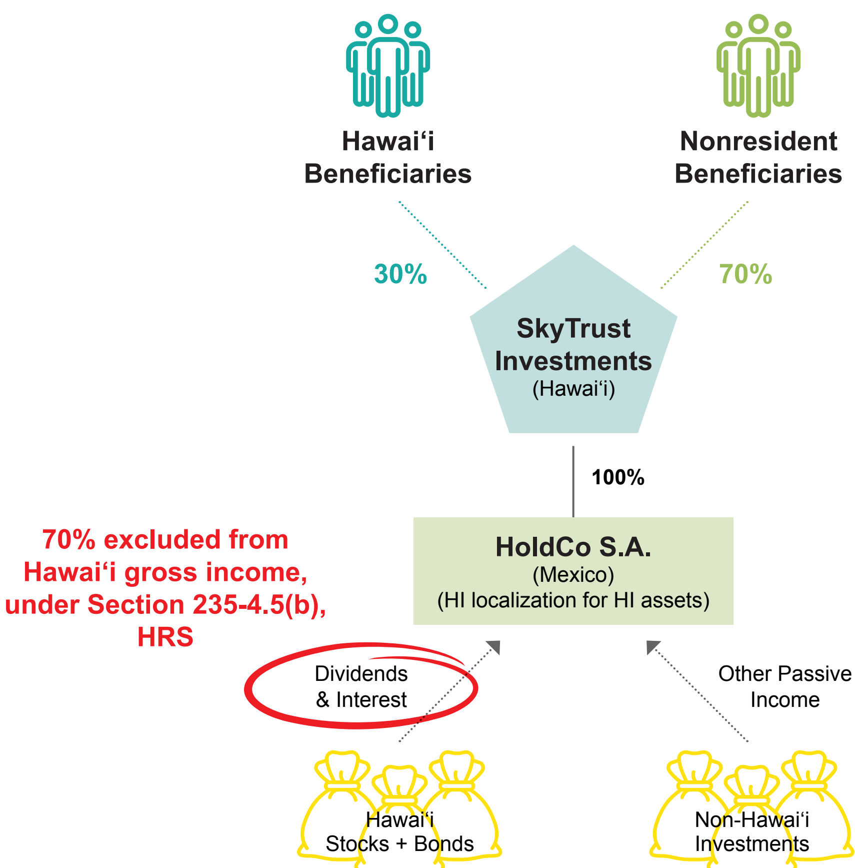
[6] This assumes no other special deductions have been taken by the trust, such as any deduction for income actually distributed to beneficiaries.

avoid business income. The exclusion aims to incentivize investment in Hawai‘i by eliminating the double taxation of a foreign corporation acting as a personal holding company, and how it does so is best illustrated by example. We also note that “foreign corporation,” for purposes of the credit, means a corporation formed outside the U.S., not simply outside Hawai‘i.

Example

- SkyTrust Investments is a Hawai‘i trust whose beneficiaries are 30 percent Hawai‘i residents and 70 percent nonresidents.
- SkyTrust Investments owns 100 percent of HoldCo S.A., a Mexico corporation.
- HoldCo S.A. invests in stocks and bonds in Hawai‘i and elsewhere, all of which generate dividends and interest.
- HoldCo S.A. possesses and controls its Hawai‘i investments from an office in Hawai‘i.

The above facts are illustrated by the diagram below.



Absent an exclusion, HoldCo S.A. should owe Hawai‘i income tax on its interest and dividends from Hawai‘i stocks and bonds because it localized its possession and control of those assets in Hawai‘i. Foreign corporations are subject to Hawai‘i tax on Hawai‘i-source income, and interest and dividends are sourced to where they are used as capital or possessed and controlled. Meanwhile, none of HoldCo S.A.'s other passive income from non-Hawai‘i investments should be taxable to Hawai‘i because foreign corporations are generally not subject to tax on income from sources outside Hawai‘i.

The exclusion under Section 235-4.5(b), HRS, allows HoldCo S.A. to ignore, for Hawai‘i income tax purposes, its intangible income to the extent that such income would be excluded to the trust's nonresident beneficiaries under Section 235-4.5(a), HRS. As Hawai‘i nonresident beneficiaries hold an aggregate 70 percent beneficial interest in the trust, 70 percent of HoldCo S.A.'s interest and dividends from Hawai‘i stocks and bonds should be excludable. Thus, the exclusion removes the potential disincentive of Hawai‘i tax, placing Hawai‘i on a level playing field with other jurisdictions that offer their own incentives. In this example, the only jurisdiction that should tax the interest and dividends from Hawai‘i stocks and bonds is the resident jurisdiction of each beneficiary. Essentially, the exclusion ensures that intangible income to a foreign corporation is excluded as a blanket rule, with no exception related to sourcing. This is in line with the general rule applicable to foreign corporations that do not localize in Hawai‘i, which is that intangible income should be non-taxable to Hawai‘i as sourced at the corporation's domicile. Ultimately, the exclusion removes the specter of multiple taxation, making Hawai‘i a tax-friendlier place to invest.

Are the exclusions meeting their purpose?

As regards eliminating double taxation, the exclusions necessarily meet that purpose. The very nature of their operation necessitates that income be excluded from Hawai‘i taxation such that only the beneficiary's resident state tax should apply. Together, Sections 235-4.5(a) and (b), HRS, ensure that Hawai‘i tax is avoided both for nonresident beneficiaries of a Hawai‘i trust and for a foreign corporation wholly owned by such trust (to the extent beneficiaries of that trust are Hawai‘i nonresidents).

As regards encouraging the development of Hawai‘i as an international center of financial services, we cannot determine the extent to which the exclusions achieve such purpose. There are no performance benchmarks identified in Sections 235-4.5(a) and (b), HRS, and a lack of data on the utilization of these exclusions deters an examination of whether and how they are used. According to DOTAX, excluded income is not reported. The Legislature's establishment of concrete metrics or benchmarks for gauging the impact of the credits on Hawai‘i's trust-related activity could help in analyzing the impacts of the exclusions.

What were the number of claimants, total amount claimed for these exclusions from 2018-2020?

These tax provisions exclude income that would otherwise be subject to Hawai‘i income tax, and DOTAX does not require taxpayers claiming either exclusion to report amounts of excluded income. Therefore, we lack data concerning the number of claimants and the amount of tax expenditure associated with the exclusions.

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

There is no data regarding the cost of the exclusions or regarding such economic activities as increased investment, tax revenue, and increased employment in finance, legal, and administrative jobs generated by taxpayers utilizing the exclusions. We lack data and analysis to support a determination as to whether the exclusions have resulted in trusts being established here that otherwise might have been established elsewhere. Therefore, we cannot conduct a return on investment calculation, cost-benefit analysis, or direct employment impact estimate.

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

We recommend that the exclusions be retained without modification. While we cannot determine whether the exclusions have generated more trust-related business in Hawai‘i, we know that they are achieving their purpose of avoiding multiple taxation. We find the goal of avoiding multiple taxation to be both reasonable and consistent with principles of tax equity.

Credit for Taxes Paid to Another Jurisdiction (Sections 235-55, 235-129, and 235-4.5(c), HRS)

SECTIONS 235-55, 235-129, AND 235-4.5(c), HRS, collectively provide a Hawai‘i income tax credit for taxes paid by a Hawai‘i resident to another jurisdiction, domestic or foreign. The first provision covers all resident individuals, the second covers S corporation shareholders, and the third covers beneficiaries of out-of-state trusts. Each credit is set forth in separate parts of Hawai‘i's tax laws, but they all provide a Hawai‘i income tax credit for taxes paid to another jurisdiction, are all ultimately claimed as a single credit, and for purposes of this report will all be referred to as a single credit, except where otherwise noted. The first of the three provisions, Section 235-55, HRS, codified in 1957, was passed as part of a package of laws intended to raise revenue and conform Hawai‘i tax law to federal tax law, notably three years after federal law allowed a federal credit for taxes paid to foreign jurisdictions. As it exists today, if a Hawai‘i state resident has derived or received income from sources outside Hawai‘i and that income is taxed by another jurisdiction, then the resident may claim a credit against Hawai‘i taxes in the amount of taxes paid to that other jurisdiction.[7]

Tax Credits at a Glance (2020)

Amount claimed	Number of Claims	Tax Expenditure	Cost Per Low-Income Resident	Meeting its Purpose?
$66 million	9,787	None	None	Yes

Relevant Legislative History

Section 235-55, HRS, Tax credits for taxes paid to another jurisdiction

1957
Act 1, First Sp SLH 1957, created the credit

Section 235-4.5(c), HRS, Taxation of trusts, beneficiaries

1985
Act 283, SLH 1985, created the credit

1988
Act 33, SLH 1988, moved the credit to Section 235-4.5(c), HRS

Section 235-129, HRS, Tax credits (S Corporations)

1990
Act 16, SLH 1990, created the credits

[7] We note that our mandate to review the S corporation provisions related to the credit for taxes paid to another jurisdiction does not identify or distinguish between different subsections of Section 235-129, HRS. Specifically, Section 23-94(c)(4), HRS, states only that we are to review "Sections 235-55 and 235-129--Credit for income taxes paid by a resident taxpayer to another jurisdiction." The credit for tax paid to another jurisdiction is specifically addressed by subsection (a) only. Subsection (b) concerns the pass-through of credits to shareholders without any specific mention or application to the credit for tax paid to another jurisdiction. We also note that a later part of our mandate, Section 23-94(c)(9), HRS, states that we are to review Section 235-129(b), HRS, specifically. Hence, it does appear from our mandate, whether from paragraph (4) or (9) of Section 23-94(c), that we are to review all of Section 235-129, HRS. However, as all of Section 235-129 concerns S corporation income tax credits, we have reported our analysis of both subsections together in this part of our report.

What do the tax credits do?

Credits for taxes paid to another state prevent double taxation, which could otherwise impede commerce between the states. Without such a credit, a taxpayer with income from a state in which that person is not resident could find the income taxed by both that state and his or her resident state, based on each state's respective laws. The example below clarifies how this can happen and how the credit resolves the issue.

> **Example 1**
> **Credit for Taxes Paid to Another State by An Individual**
>
> Mary Smith is a resident of Hawai'i who worked for a summer in California, providing services for compensation.
>
> California taxes nonresidents on their income earned in California. Consequently, Mary's earnings from work in California should be taxable to California.
>
> Hawai'i taxes residents on their worldwide income, regardless of where it is earned. As Mary is a resident of Hawai'i, her summer earnings should be taxable to Hawai'i.
>
> California and Hawai'i, under their respective laws alone, may both tax Mary. Without a credit or other remedy in place, Mary could be subject to double taxation, paying both California tax and Hawai'i tax on the same summer income. Working across state lines triggers tax by two states, whereas had she stayed in Hawai'i, she would have owed tax to one state only. In other words, without a credit, the tax scheme would discriminate against interstate commerce.
>
> The credit codified at Section 235-55, HRS, allows Mary to claim her taxes paid to California against her tax due to Hawai'i. That means her summer income taxable by California should be taxed by California only. Thus, Hawai'i residents may work and otherwise engage in commerce across state lines without discriminatory tax impact. The credit prevents discrimination against interstate commerce.

The Section invoked in the example above prevents double taxation for individuals directly, while Sections 235-129 and 235-4.5(c), HRS, ensure a similar result in contexts specific to S corporations and trusts. With respect to S corporations, Section 235-129, HRS, ensures that the credit will pass through to S corporation shareholders, even for an S corporation formed or operating in a state that does not treat S corporations as pass-through entities. With respect to trusts, Section 235-4.5(c), HRS, ensures that the credit will pass to beneficiaries for trusts formed in states that tax the trusts. How these provisions accomplish such results is explored in the following paragraphs.

How does the tax credit work?

The credit works as a dollar-for-dollar offset against tax owed. It is claimed on Schedule CR, Schedule of Tax Credits. On that schedule, the credit is added to all other nonrefundable credits, yielding a sum that the taxpayer reports on its tax return. On that return, the sum of nonrefundable credits is subtracted from tax owed to determine balance owed (prior to factoring in payments made).

In the case of a Hawai‘i S corporation taxed by states not recognizing the S corporation as fully pass-through, the credit would first appear on the Hawai‘i S corporation return, Form N-35, then flow to a document displaying the relevant shareholder’s share of S corporation tax items, Schedule K-1, then get aggregated with other credits on Schedule CR, and finally be reported on the shareholder’s individual return, Form N-11. Ultimately, it is the individual shareholder who benefits from the credit, on that individual tax return. Similarly, in the trust context, the taxpayer that ultimately benefits from the credit is not the trust itself, but the individual beneficiary – or beneficiaries, if there are multiple.

The amount to declare on Schedule CR is determined by a complex calculation for which DOTAX has published a worksheet. The fine details of that calculation are not necessary for purposes of this report, but some rules surrounding the credit bear mention:

No Credit on Excluded/Exempt Income

No credit may be claimed for tax paid on income that is excluded or exempt from taxation. For example, out-of-state tax paid on intangible income excluded under the Hawai‘i exclusion reviewed at the start of this report is not creditable.

Income Tax Only

To be credited, the tax paid must be an income tax – not a sales tax, franchise tax, or other distinct type of tax.

Paid Tax Only

The tax must have been paid, not simply accrued.

No Double Crediting

No Hawai‘i credit is allowed for tax paid to a foreign country and already credited on a federal return.

Nonrefundable

The credit is limited to the amount of tax otherwise owed.

S Corporation Pro Rata Crediting

With respect to Hawai‘i S corporations taxed by other jurisdictions, the Hawai‘i pass-through of tax paid is always pro rata by shareholder interest. For example, a 10 percent shareholder may claim a credit for 10 percent of the tax paid by the S corporation. Similarly, any credit earned by an S corporation and passed through to its shareholders, such as a renewable energies credit or film production credit, must be passed pro rata.

With regard to S corporations, two distinct subsections of Section 235-129, HRS, concern credits, but only one targets credits for taxes paid to another jurisdiction. Subsection (a) is the primary subsection allowing, indirectly, a credit for tax paid to another jurisdiction. That subsection applies when an S corporation has actually paid tax to another jurisdiction. The subsection deems the tax paid by the S corporation to have been paid by its shareholders, on a pro rata basis. Deeming the shareholders the payers of the out-of-state tax allows those shareholders to claim the credit under the rule applicable to individuals, codified at Section 235-55, HRS. Hence, it is the individual that ultimately claims the credit, on his or her personal tax return. The second subsection of Section 235-129, HRS, subsection (b), concerns not tax paid, but credits earned by the S corporation in Hawai‘i. The subsection does not specify any particular type of credit, such that any type of credit – such as the Credit for Research Activities or the Renewable Energy Technologies Credit – could be passed through to the shareholders. An S corporation need not have paid tax for subsection (b) to apply; it need only have earned a credit in Hawai‘i. Consequently, we do not see subsection (b) as relevant to a review of provisions on credits for taxes paid to another jurisdiction, which would be claimed under subsection (a). Still, we review subsection (b) because our mandate under Section 23-94(c)(4), HRS, covers all of Section 235-129, HRS. Furthermore, our mandate under Section 23-94(c)(9), HRS, explicitly includes review of Section 235-129, subsection (b), HRS.

Example 2
Credit for Taxes Paid to Another State by An S Corporation

<u>Facts</u>:
Mary Smith is a resident of Hawai‘i. She owns 100 percent of SmithCo LLC.

SmithCo LLC is a limited liability company formed in the State of Georgia that has elected to be treated as an S corporation for federal income tax purposes. SmithCo is a landlord. It made $100,000 in profits from rentals in Hawai‘i and Georgia.

<u>Hawai‘i Results to SmithCo</u>:
Hawai‘i recognizes the federal S election. Consequently, SmithCo should owe no Hawai‘i tax, regardless of the fact that some of its rentals are in

Hawai‘i, as all profits are passed through to its shareholder for income tax purposes.

Georgia does not recognize a federal S election unless all shareholders sign an additional consent form that Mary never signed. Consequently, SmithCo should owe corporate income tax to Georgia. Let us assume the corporate rate is 10 percent, such that SmithCo owes $10,000. While we are focused on Hawai‘i, this Georgia tax affects the Hawai‘i results to Mary.

Hawai‘i Results to Mary:
Mary, as a Hawai‘i resident, is taxed by Hawai‘i on her worldwide income, including her pass-through share of business profits. As she owns 100 percent of SmithCo, she must pay Hawai‘i tax on all $100,000. Let us assume that Mary pays tax at a 15 percent rate, such that her tax should be $15,000. **Now, we note that Mary is also entitled to a credit for her share of taxes paid by her S corporation to another jurisdiction: Georgia.** SmithCo paid $10,000 to Georgia, and Mary owns 100 percent of SmithCo, so Mary may offset her Hawai‘i tax by that amount. Her tax of $15,000, offset by $10,000 in credit, equals a tax balance due of $5,000. Ultimately, Mary must pay to the State of Hawai‘i $5,000, her personal income tax liability.

What is the purpose of each tax credit?

The original Hawai‘i tax credit for tax paid to another jurisdiction, which concerned individual claims without reference to trusts or business entities, was enacted as part of the Income Tax Law of 1957 (later known as the 1957 Tax Act), which the Legislature intended to raise revenue and conform Hawai‘i Territory tax law to U.S. federal tax law. The U.S. federal tax code had been rewritten in the Internal Revenue Code (IRC) of 1954, and the Hawai‘i Territory tax code was rewritten in the 1957 Tax Act. The Hawai‘i tax credit for tax paid to another jurisdiction came three years after passage of the federal tax credit for tax paid to another jurisdiction

According to DOTAX, the purpose of the credit was and is to prevent double taxation and thus to avoid impeding interstate commerce. More specifically, according to DOTAX, the purpose is to maintain conformity with U.S. Supreme Court decisions holding that taxation on the same income by multiple jurisdictions is unconstitutional discrimination against interstate commerce. Example 1, above, demonstrates how double taxation could discriminate against interstate commerce and how the credit prevents such from occurring.

Regarding later expansion of the credit to certain trust beneficiaries via Section 235-4.5(c), HRS, that subsection was added to incentivize trusts to be located in Hawaiʻi by removing the double taxation that existed prior to enactment. According to a Senate Ways and Means Committee report on the bill that would become Act 283, SLH 1985, Hawaiʻi law at the time taxed income regardless of a trust beneficiary's residence, resulting in double taxation of a nonresident trust beneficiary. The Committee stated, "Hawaiʻi is at a disadvantage in attracting trusts from foreign sources, for they tend to look to states that do not tax nonresidents on trust income." It added that trust companies also signify a desirable type of business to attract because they provide employment without pollution or adverse consequences and are essential if Honolulu wishes to become a financial center of the Pacific.

Regarding the expansion of the credit to certain S corporation shareholders via Section 235-129, HRS, the purpose was twofold. First, the section was to standardize the tax treatment of S corporations, bringing Hawaiʻi into conformity with the Model S Corporation State Income Tax Act (the Model Act). Second, it was to provide an incentive for nonresident shareholders of S corporations to file their returns in Hawaiʻi, noting that the Legislature originally drafted Section 235-129, subsection (b), HRS, to allow nonresident shareholders the same credits (with one exception) allowed to resident shareholders. The Legislature has substantially revised that subsection since the original version, which we discuss in more detail below.

Are the tax credits achieving their purpose?

The credit for tax paid to another jurisdiction, by its very operation, achieves its overarching purpose of eliminating double taxation. Its operation involves offsetting Hawaiʻi tax exactly to the extent of tax paid to another jurisdiction up to the amount of Hawaiʻi tax otherwise due. Taxpayers claiming the credit should not be suffering from double taxation; they should be avoiding Hawaiʻi tax.

With respect to the purpose specific to the expansion of the credit to certain trust beneficiaries, we lack the data necessary to determine whether the credit has attracted nonresident investment via business trusts. There is no information, collected by DOTAX or in the legislative history of the credit, on the motives behind forming and closing such trusts. As stated above, however, the credit does resolve a double taxation concern that existed prior to enactment of the credit.

With respect to the purpose specific to the expansion of the credit to certain S corporation shareholders, subsection (a) of Section 235-129, HRS, achieves its purposes. That is because subsection (a) conforms to the Model Act, its language matching almost verbatim the corresponding Section 1008, subsection (a), of the Model Act. Subsection (b) of

Section 235-129, HRS, by contrast, differs from Model Act language, but supports a separate purpose of allowing credits afforded to an S corporation to be passed down to shareholders.[8]

What were the number of claimants, total amount claimed for the tax credits from 2018-2020?

Year	2018	2019	2020
Number of Claims	9,971	10,222	9,787
Tax Credits Claimed	$51.5 million	$56.4 million	$66 million

Source: DOTAX 2018, 2019, and 2020 *Tax Credits Claimed by Hawai‘i Taxpayers* reports

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

We recommend that the Legislature retain Sections 235-4.5(c), HRS, and subsection (a) of Section 235-129, HRS, without modification. Those provisions achieve their purpose of preventing double taxation, ensuring that the State of Hawai‘i not violate the interstate commerce clause of the U.S. Constitution. Indeed, retaining the credit is necessary to maintain compliance with federal judicial doctrine on that constitutional issue.

We recommend that Section 235-55, HRS, also be retained, for the same reasons cited in the paragraph above, but with one minor modification. We recommend that, in Section 235-55(b)(1), HRS, “1954” be replaced with “1986, as amended.” As written, Section 235-55(b)(1), HRS, refers to the Internal Revenue Code of 1954, apparently not reflecting the fact that the Internal Revenue Code was rewritten in 1986 and thereafter amended. Our recommendation assumes that the Legislature seeks to have Section 235-55(b)(1), HRS, refer to the latest version of the Internal Revenue Code.

Finally, we recommend that the Legislature retain subsection (b) of Section 235-129, HRS, without modification. While subsection (b) does

[8] Subsection (b) of Section 235-129, HRS, allows a shareholder a pro-ration of “the tax credit earned by the S corporation in this State.” Use of “the tax credit” seems to imply a single or aggregate credit only. Given the proximity of subsection (b) to (a), the latter concerning taxes paid to another jurisdiction, “the tax credit” might be interpreted as the credit for taxes paid to another jurisdiction. The Model Act, however, refers to a plurality of credits, allowing S corporation shareholders a pro-ration of “policy tax credits available to a C Corporation.” The original draft of Section 235-129(b), HRS, followed that Model Act language, allowing pass-through treatment of “tax credits described in sections 209E-10, 235-12, 235-71(c), 235-110.6, 235-110.7, and 235-110.8.” The original draft also explicitly allowed nonresidents the same credits allowed to residents, to the extent the credits were earned in the State. Today, by its unclear reference to “the tax credit,” and by its lacking any credit allowance specifically for nonresidents, subsection (b) of Section 235-129, HRS, deviates from the Model Act. It thus fails to meet its original purpose of bringing Hawai‘i into conformity with the Model Act.

not conform exactly to the Model S Corporation Income Tax Act, it does ensure the pass-through treatment of tax credits from S corporations to their shareholders. If the Legislature intended for our office to review subsection (b) of Section 235-129, HRS, separately from our review of subsection (a) of Section 235-129, HRS, then we also recommend amending our mandate to reflect that in Section 23-94(c)(4), HRS.[9]

[9] As noted in our introductory paragraphs to this credit, our mandate appears to require review of subsection (b) of Section 235-129, HRS, twice. The first time is in Section 23-94(c)(4), HRS, which mandates us to review Section 235-129, HRS, without specifying any particular subsection. The second time is in Section 23-94(c)(9), HRS, which mandates us to review subsection (b) of Section 235-129, HRS, specifically. It is our belief that subsection (b) was intended to be listed separately for review because subsection (b), as we note in our discussion above, appears to relate to all credits earned by an S corporation – not simply to the credit for taxes paid to another jurisdiction. If the Legislature intends to have Section 23-94(c)(4), HRS, mandate us to review the credit for taxes paid to another jurisdiction, and that credit only, then we recommend that the Legislature modify our mandate in Section 23-94(c)(4), HRS, to cover only subsection (a) of Section 235-129, HRS.

Tax Credit for Capital Gains Tax Paid by a Regulated Investment Company (Section 235-71(c), HRS)

THIS CREDIT allows a shareholder of a regulated investment company (RIC) to offset income tax incurred from its share of any undistributed capital gains recognized by the RIC. If a RIC pays tax on capital gains and its shareholders include those gains on their personal returns, then those shareholders may claim the credit to avoid paying tax, personally, on those same gains. Without the credit, tax would be paid at least twice: once at the entity level by the RIC and a second time at the individual level by the shareholder – and even if the shareholder never actually received the gains. Thus, the provision prevents payment of a double tax. Understanding of this credit requires first discussing what a RIC is and when it would be subject to capital gains tax.

Hawai‘i tax law defines a RIC as a corporation qualifying as a RIC under federal tax law. Under federal tax law, a corporate RIC must be either of two types of companies and must pass certain income and asset tests. The first type of corporate RIC is a corporation registered under the Investment Company Act of 1940 (the ‘40 Act) as a management company or unit investment trust. The second type is a corporation that has elected to be treated as a business development company. Both types are, under the ‘40 Act, “investment companies,” meaning they hold themselves out as being engaged, or propose to engage, primarily in the business of investing or trading in securities. The income test is that at least 90 percent of the company’s gross income derive from dividends, interest, securities loan payments, and gains from sales of, and other investments in, securities and foreign currencies. The asset test is that at least 50 percent of the company’s assets be represented by cash, government securities, and securities of other RICs. We note that mutual funds are often RICs.

Once a corporation qualifies as a RIC, it both benefits from certain federal tax benefits and risks a federal capital gains tax. The primary benefit is that, if the company distributes at least 90 percent of its income to its shareholders, its capital gains – gains from sale of assets – should be excluded from federal taxation. Thus, even though a RIC is generally taxed as a corporation, it is not taxed on capital gains. Neither do the capital gains “pass through” the RIC to the shareholders, as the capital gains are completely excluded. The risk is that, if the RIC does not meet the distribution requirement, then it becomes subject to a tax on undistributed capital gains at the corporate level and rate and its shareholders must include in their income the undistributed capital gains. The income must be recognized for tax purposes, even though it is not actually distributed to the shareholder. Such income – income not received, but treated as received or otherwise taxable – is known as “phantom income.” The federal provision mandating the income inclusion is codified at Section 852(b)(3)(D) of the Internal Revenue Code, which is the federal law cited by the Hawai‘i tax credit under review.

Hawai‘i conforms to the federal code with respect to RICs, except as regards tax rates and the capital gains tax credit we now review. This conformance means that, when a RIC fails the 90 percent distribution test, Hawai‘i does tax the RIC at the corporate level on undistributed capital gains. The credit offsets the Hawai‘i tax at the shareholder level by the amount the shareholder would have had to pay on income it had to include under the phantom income rules mentioned above. Such offset remedies double taxation, in this case meaning taxation at both the RIC level and shareholder level. It also prevents a predicament wherein a shareholder, to whom gains were not in fact distributed, would suffer tax without having received income sufficient to pay such tax – in other words, avoiding the taxing of one without the wherewithal to pay.

Tax Credit at a Glance (2020)

Amount claimed	Number of Unique Claimants	Tax Expenditure	Cost Per Low-Income Resident	Meeting its Purpose?
$11,014	7	None	None	Yes

*Cost per low-income resident used is the amount claimed per year divided by a low-income resident figure of 480,801 derived from Department of Business, Economic Development and Tourism data

Relevant Legislative History

Section 235-71(c)

1957

Act 1, First Special Session 1957, created the credit at 2.75 percent of the amount of capital gains under Section 852(b)(3)(D) of the Internal Revenue Code of 1954 on which tax has been paid to the Territory of Hawai‘i by the regulated investment company

1965

Act 155, SLH 1965, increased the credit to 3.08 percent to correspond with a tax rate increase

1987

Act 239, SLH 1987, changed the credit to correspond to the amount of tax imposed on capital gains that by Section 852(b)(3)(D) of the Internal Revenue Code must be included in income by the shareholder, rather than the specific 3.08 percent of such gains

What does this tax credit do?

The tax credit prevents a RIC shareholder from having to pay tax on income he or she never received, also known as “phantom income.” As the income was never actually received by the shareholder, unless the shareholder has assets from other sources, the shareholder lacks the money to pay the tax. The credit offsets the tax, avoiding an inability-to-pay predicament.

The phantom income, in this context, is the income that a shareholder of a RIC must recognize when that RIC does not distribute at least 90 percent of its capital gains for the year. The general rule is that a RIC, by virtue of its status as a RIC, may exclude capital gains. However, if the RIC fails to distribute at least 90 percent of those gains, it loses that benefit and its capital gains become taxable at the corporate level. A secondary effect, statutorily prescribed, is that those same gains become taxable to each shareholder, at the shareholder level. In short, if a RIC fails the 90 percent test, its shareholders have more income. The shareholders did not actually receive income – as it was not distributed – but they must declare the income as taxable on their tax returns. Recognizing additional income triggers an additional tax to the shareholders, but the credit offsets that tax such that the shareholders need not pay it.

How does this tax credit work?

Assume the following facts:

- MF is a mutual fund and RIC. Its income consists of capital gains only, all *not* from Hawai‘i sources.
- The applicable Hawai‘i corporate tax rate is 6.4 percent.
- Tom is a Hawai‘i resident and 15 percent shareholder of MF. Tom pays personal income tax at a 22 percent rate.
- All other MF shareholders are nonresidents of Hawai‘i and are irrelevant.

<u>2021 (Fail 90 percent test; credit claimed)</u>

In 2021, MF realized $100,000 in capital gains and no other income.

MF distributed $60,000 of capital gains to its shareholders, pro rata. It reinvested $40,000.

Tom received 15 percent of that $60,000 distribution: $9,000

- Hawai‘i Result to MF:

  MF fails the 90 percent test, and therefore, all its income is subject to corporate taxation.

  At the tax rate of 6.4 percent, MF is liable for **$6,400** in tax on its income of $100,000.

- Hawai‘i Result to Tom:

  Tom must recognize as income his $9,000 dividend distribution.

  Tom also must recognize as income his share of undistributed capital gains ($40,000). [Phantom income.]

  Based on his 15 percent interest in MF, Tom's share of MF's undistributed capital gains equals $6,000. His total income for Hawai‘i tax purposes is now $15,000.

  At a 22 percent tax rate, Tom owes (before payments and credits) $3,300.

  Tom uses the RIC credit to offset his tax by the amount attributable to his undistributed gains, which equals 22 percent of $6,000, or $1,320. [Tax on phantom income.]

  Owing tax of $3,300, <u>but claiming a credit of $1,320</u>, Tom pays **$1,980** in tax relating to his distribution from and interest in MF (which is the tax owed on the $9,000 dividend distribution).

- Hawai‘i Total Result (taxes paid by MF and Tom, combined): **$8,380**.

What is the purpose of this tax credit?

The legislative history underlying Act 1, First Special Session 1957, contains general statements that the act was carefully designed to "correct the critical financial condition" of the territorial and county governments and to correct certain "glaring inequities and injustices" in the then-existing tax code. While the legislative history does not provide details as to the financial condition or inequities of the time, we believe that the "glaring inequities" included the taxation on phantom income, and consequent double taxation, that would exist without the credit. The double taxation would be from taxation by Hawai‘i at two distinct levels: the entity level, meaning the taxation upon the RIC, plus the shareholder level, meaning the taxation upon each individual investor.

Without this credit, a RIC shareholder would have to pay tax on income from undistributed capital gains. The shareholder would not have, in fact, received a dividend, but would be subject to tax nonetheless. As detailed in our above section on what the credit does, such a predicament would also lead to taxation of the undistributed capital gains at both the corporate and shareholder levels. The credit eliminates the double taxation, in line with principles of tax equity.

Is the tax credit meeting its purpose?

Yes, the tax credit achieves the purpose we believe it is designed to achieve. As detailed in previous paragraphs, the credit eliminates an inequitable tax on phantom income and simultaneously prevents double taxation.

What were the number of claimants and total amounts claimed for the tax credit for 2018-2020?

The DOTAX Tax Credits report from 2020 does not include data on this tax credit. DOTAX stated in that report, and reiterated to our office directly, that the RIC credit (and an unrelated credit) “are not proper tax credits, but are instead deductions from income tax that account for Hawai‘i income taxes already paid, similar to the deduction for taxes that were withheld on wages.” We understand from that statement that DOTAX considers the “credit” to be a payment of tax, which would be reported farther along in the relevant tax return than where credits are reported – similarly to how wage withholdings, which are payments, are reported. However, the Hawai‘i resident individual income tax return lacks a line item for such a payment, and we note that the DOTAX instructions to that return indicate that the credit from a RIC is a “credit” to be reported on line Schedule CR. Schedule CR, entitled the Schedule of Tax Credits, has a line specifically for the “Credit From a Regulated Investment Company.” As noted earlier, the law also refers to the credit as a “credit” and states that it should be applied as credits are applied.

At our request, DOTAX provided us with two years of data regarding claims of this tax credit. The data showed that the number of taxpayers claiming the credit and the amounts claimed were minimal. According to DOTAX, it is unusual for regulated investment companies to pay the tax because a RIC will usually distribute all of its capital gains in part to avoid the tax, which is viewed as a *de facto* penalty. The lack of any tax paid by a RIC should mean a lack of any credit claimed by RIC shareholders.

Year	2018	2019	2020
Number of Claims	Not provided	22	7
Tax Credits Claimed	Not provided	$17,590	$11,014

Source: DOTAX communications

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

There is no data showing any correlation or causation between claims of the tax credit and economic or employment benefits to Hawai‘i. Given that the grand total amount of credit claimed, among all taxpayers, was under $20,000 for each of the two years for which we have data, we believe that any economic effect upon the State is negligible.

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

We recommend that the Legislature retain the credit. Repealing the credit would allow double taxation of income, and we are unaware of any reason to modify the credit at this time.

Fuel Tax Credit for Commercial Fishers (Section 235-110.6, HRS)

SECTION 235-110.6, HRS, provides a refundable tax credit to Hawai‘i residents who are the principal operators of commercial fishing vessels to offset fuel tax costs resulting from a Fuel Tax on distributors. Hawai‘i applies a Fuel Tax via Section 243-4, HRS, on a distributor of liquid fuel for each gallon of liquid fuel sold or used in the State by the distributor.

Tax Credit at a Glance (2020)

Amount claimed	Number of Claims	Tax Expenditure	Cost Per Low-Income Resident	Meeting its Purpose?
$429,000	106	$429,000	89 cents*	Unable to Determine

*Cost per low-income resident used is the amount claimed per year divided by a low-income resident figure of 480,801 derived from Department of Business, Economic Development and Tourism data.

Relevant Legislative History

Section 235-110.6

1981
Act 210, SLH 1981, created the tax credit

2010
Act 192, SLH 2010, amended the credit to require any refundable portion of the credit to be paid from the State Highway Fund

What does this tax credit do?

The credit provides resident commercial fishers with relief from fuel taxes, presumably passed from distributors in the form of higher prices, to the extent that fuel purchased is used for fishing operations. It allows each resident commercial fishing vessel principal operator to offset its income tax by the amount of fuel tax that should have been paid by the distributor when that fuel was sold. The operator reports volumes of fuel purchased and used to operate its vessels and, from those volumes, calculates the tax that would be due on the sale of the fuel under Section 243-4(a), HRS. The credit equals that calculated tax amount, as described in greater detail in the next section. A commercial fishing vessel is defined as any water vessel used to catch or process fish or transport fish loaded on the high seas. A principal operator is any Hawai‘i resident individual or corporation that derives at least 51 percent of its income from commercial fishing operations.

How does this tax credit work?

The credit is calculated using a form published specifically for it, Form N-163, “Fuel Tax Credit for Commercial Fishers.” The fisher intending to claim the credit lists the volumes and types of fuel purchased and used in commercial fishing operations. For each type of fuel, the tax rate applicable to that type is multiplied by the gallons for that type, resulting in an arithmetic product that should match the Fuel

Tax paid by distributor on such fuel. Those products are then summed, resulting in the total claimable Fuel Tax credit.

We note here that the fisher need not know how much (or even whether) the distributor actually paid in tax because the amounts used for the credit are calculated from volumes of fuel used. Essentially, completion of Form N-163 implies a presumption that the Fuel Tax that should have been due, given volumes and types of fuel purchased and used, was in fact paid by the distributor. This does create a risk of a mismatch between qualified amounts actually paid, meaning creditable, and amounts credited – a risk we discuss in more detail later in this report. Once the total Fuel Tax credit is calculated, it flows to the relevant tax return. On the tax return, the credit acts as a negative against income tax, reducing any balance due to the State.

What is the purpose of this tax credit?

The purpose of this credit is to incentivize commercial fishing by refunding to commercial fishers the Fuel Tax paid on liquid fuel, based on the Legislature's belief that the commercial fishing industry has the potential to become a much larger sector of Hawai‘i's economy. At the time the credit was enacted, the conference committee reported that little progress had been made in developing the industry during the prior 50 years despite abundant resources. In particular, the committee pointed to fishery resources in waters around the Leeward Islands, stretching beyond the then-200 mile federally established Fisheries Conservation Zone.

Is the tax credit meeting its purpose?

There is insufficient information available to prove any correlation or causation between the Fuel Tax credit and any expansion of commercial fishing in Hawai‘i, but the data we do have seems to suggest that the credit is not a driving factor in the economics of commercial fishing. First, year after year, over 96 percent of commercial fishers do not utilize the credit, implying that it is not a motivating factor for those fishers. In 2018, only 121 out of 3,561 commercial fishers, or roughly 3.4 percent of the industry, claimed the credit. In 2019, 124 of 3,484, or 3.6 percent, claimed it. In 2020, 106 of 3,135, or 3.4 percent, claimed it. Secondly, the number of commercial fishers and pounds of fish landed have fluctuated significantly since 2004, despite the lack of any substantive[10] change to the credit – further suggesting the lack of any impact the credit might have had on the industry. From 2004 through 2012, the number of commercial fishers rose from 2,971 to 3,992, a growth of over 34 percent. Pounds of fish landed also rose steadily, from 22.23 million to 31.79 million, signifying a growth of 43 percent over the same period. The years immediately after, from

[10] The credit was amended once, in 2010, to have its refundable portion come from the state highway fund. All that changed was the source of funds.

2013 through 2018, appear to be a period of consolidation, as pounds of fish landed continued to rise – to 37.49 million – while the number of fishers declined, to 3,561. Since 2018, both the number of fishers and the pounds of fish landed have declined significantly – the former by 12 percent and the latter by 22 percent. The small number of claimants coupled with industry changes despite a stagnant credit lead us to believe it unlikely that the credit, currently, is a driving factor in the expansion and contraction of commercial fishing in Hawai‘i.

As the credit appears not to be a driving factor in the direction of the commercial fishing industry, we postulate that it has not achieved its purpose of encouraging commercial fishing. In short, we believe the credit has little to no effect on the economy.

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

Year	2018	2019	2020
Number of Claims	121	124	106
Tax Credits Claimed	$372,000	$415,000	$429,000

Source: DOTAX 2018, 2019, and 2020 *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?

From 2018 through 2020, fewer than 4 percent of all commercial fishers claimed the credit. The credit also had no noticeable impact on fluctuations in the commercial fishing industry. In short, the credit has no, or negligible, economic or employment benefit to Hawai‘i.

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

While we lack critical data, we suspect that the credit is not achieving its originally intended purpose of enlarging the commercial fishing sector in Hawai‘i. The credit is being claimed by fewer than 4 percent of all commercial fishers and seems to have no discernable effect on the number of commercial fishers or pounds of fish landed. As far as data available reveals, repealing the credit should save expenditure dollars likely without significant impact to the economy or welfare of the State. Based on the data available, we recommend repeal of the Fuel Tax Credit for Commercial Fishers.

Tax Credit for Important Agricultural Land Qualified Agricultural Costs (Section 235-110.93, HRS)

THE IDENTIFICATION AND DESIGNATION of "Important Agricultural Lands" was first proposed at the 1978 Constitutional Convention and subsequently approved by voters in the same year. Article XI, Section 3, of the State Constitution requires the State to conserve and protect agricultural lands, promote diversified agriculture, increase agricultural self-sufficiency, and assure the availability of agriculturally suitable lands. Important agricultural lands are lands that are capable of producing sustained high agricultural yields when treated and managed; contribute to the State's economic base; produce agricultural commodities for export or local consumption; or promote future expansion of agricultural activities and income. Act 183, SLH 2005, established standards, criteria and mechanisms to identify Important Agricultural Lands and to implement the intent behind Article XI, Section 3 of the Hawai‘i Constitution. Act 183 also mandated that the State and each county ensure that their agricultural development, land use, water use, regulatory, tax, and land protection policies, as well as permitting and approval procedures, would enable and promote the economic sustainability of agriculture. Three years later, intending to satisfy such mandate, the Legislature passed Act 233, SLH 2008, which established various incentives to establish and sustain viable agricultural operations on Important Agricultural Lands. One such incentive, passed as part of Act 233, was the tax credit for qualified costs related to establishing and sustaining such lands, codified at Section 235-110.93, HRS.

Tax Credit at a Glance (2020)

Amount claimed	Number of Claims	Tax Expenditure	Cost Per Low-Income Resident	Meeting its Purpose?
$0	0	$0	$0	Unable to Determine

Relevant Legislative History

Section 235-110.93

2008

Act 233, SLH 2008, created the credit

2014

Act 101, SLH 2014, clarified the amount of tax credit

2018

Act 87, SLH 2018, provided additional time for certification of such tax credits to allow landowners and farmers to claim the tax credit in the event their agricultural lands are identified as potential Important Agricultural Lands. It also set a date of December 31, 2021, after which previously granted, but unused credits could be claimed, but no new credits would be certified

2022

Act 139, SLH 2022, extended the credit through 2030

What does this tax credit do?

Section 235-110.93, HRS, allows a refundable income tax credit for amounts spent on qualified agricultural costs. Qualified agricultural costs include expenditures for the plans, design, engineering, construction, renovation, repair, maintenance, and equipment for:

- roads or utilities that are primarily for agricultural purposes on lands that are Important Agricultural Lands;
- certain agricultural processing facilities;
- water wells, reservoirs, dams, pipelines, water storage facilities, and irrigation systems providing water primarily for Important Agricultural Lands; and
- housing occupied by farmers or employees of agricultural businesses and owned by the agricultural business.

Eligible costs also include feasibility studies, regulatory processing, and legal and accounting services related to expenditures listed above; equipment used to cultivate, grow, harvest, or process agricultural products; and regulatory processing, studies, and legal and other consultant services related to obtaining or retaining water for agricultural activities and retaining the right to farm on Important Agricultural Lands.

A taxpayer can claim the tax credit for a total of three years, which do not have to be consecutive, in amounts as follows:

- In the first year, the tax credit is the lesser of 25 percent of qualified costs or $625,000;
- In the second year, the credit is the lesser of 15 percent of qualified costs or $250,000; and
- In the third year, the lesser of 10 percent of qualified costs or $125,000.

Taxpayers may also delay claiming the tax credit to any year after the year in which qualified costs were incurred, so long as the credit remains available. Given that greater expenses may already result in lower tax by virtue of lowering income, and given that the credit may not be claimed in a year for which another agricultural credit is claimed, and finally given that certain other factors (such as receipt of State irrigation funds) may limit the credit, a taxpayer may very well desire to delay claiming the credit to a later year.

How does this tax credit work?

Claiming this credit is a multistep process involving both the Hawai‘i Department of Agriculture (HDOA) and DOTAX.

> **Step 1** is for a prospective claimant to submit to the HDOA a Request for a Certification of Important Agricultural Lands Costs form. That form includes basic taxpayer information and details as to which expenditures the taxpayer purports to have qualify for the credit. HDOA must certify that the expenses qualify, lest the credit be disallowed.
>
> **Step 2** is for the prospective claimant to complete and attach Form N-344, *Important Agricultural Land Qualified Agricultural Cost Tax Credit*, to its income tax return. Notably, that form should include the HDOA certification from Step 1.
>
> **Step 3** is to complete the rest of the return. As with other credits discussed in this report, this credit flows from its particular form – in this case Form N-344 – to Schedule CR. On Schedule CR, it is aggregated with other refundable credits, whose sum is reported directly on the relevant tax return.
>
> **A further step, Step 4**, is optional and for taxpayers seeking to claim the credit for more than one year. Such a taxpayer must annually submit an HDOA Outcome Assessment Report, lest HDOA inform DOTAX that a certification previously issued is no longer valid.

No more than $7.5 million in certified credits can be claimed annually. If in any taxable year the annual total of certified credits reaches that amount, HDOA must immediately discontinue certifying credits. Credits are thus granted at the discretion of HDOA and on a first come, first served basis.

What is the purpose of this tax credit?

The tax credits are intended to aid in establishing and sustaining viable agricultural operations on Important Agricultural Lands.

Is the tax credit meeting its purpose?

Utilization of the tax credit has been limited. According to HDOA, as of December 2021, only 13 private landowners received Important Agricultural Lands designations from the Land Use Commission, and all are on O‘ahu. The total area designated as Important Agricultural Lands, as of December 2020, was 136,489 acres. HDOA speculated that a reason there are few applicants for this credit is that only one county – the City and County of Honolulu – has formally identified potential

Important Agricultural Lands for Land Use Commission approval. Our analysis was also limited by sparse reporting on the credit between HDOA and DOTAX. HDOA published two annual reports covering the credit for legislative session years 2021 and 2022, as required by statute, but the reports lack critical information. While the HDOA reports provide that no claims were filed in 2020 and provide the number of claims filed in 2018 and 2019, they do not include an evaluation of the effectiveness of the credit in encouraging the development of agriculture businesses, contrary to HDOA's statutory mandate. We also note that the HDOA report was not prepared in consultation with DOTAX, again contrary to the statutory mandate. DOTAX publishes its own Tax Credits report for each year, and its report for 2020 stated that there were no claims in 2020 and that all data on the credit for 2018 and 2019, including the number of claims, must be suppressed to preserve the confidentiality of taxpayer information. DOTAX has previously reported its policy to withhold the number of taxpayers claiming a particular incentive when that number is five or fewer. That is to prevent readers from being able to identify any particular taxpayer. In line with the same goal of protecting taxpayer confidential information, we also do not disclose the exact number of claimants in this report.

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

Year	2018	2019	2020
Number of Claims	Suppressed*	Suppressed*	$0
Tax Credits Claimed	Suppressed*	Suppressed*	$0

*Data on the tax credit have been suppressed to prevent potential disclosure of confidential taxpayer information, in line with DOTAX policy and *Government Auditing Standards*.

Source: DOTAX 2018, 2019, and 2020 *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?

Although HDOA is tasked with reporting on the effectiveness of this incentive and its encouraging of the development of agricultural businesses, its reports do not contain such information. As there are no performance benchmarks identified in Section 235-110.93, HRS, and there is insufficient available information regarding the economic impacts resulting from the credits, we cannot conduct a return on investment calculation, cost-benefit analysis, or estimate the direct employment impact.

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

We lack sufficient relevant data and analysis to support a determination of whether the tax credit should be retained without modification, amended, or repealed. Definitive conclusions about whether the credit achieves its purposes cannot be drawn without sufficient relevant data and metrics or benchmarks for gauging impact on Hawai‘i's agricultural industry, job and revenue creation, and self-sufficiency in food production, among other things. While independent, objective, and well-suited to conducting 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 this particular tax credit. Therefore, we are unable to determine whether the credit should be retained or repealed.

We also note that low public utilization of the credit, and consequent scarce data regarding the credit, may change with increased county participation in Important Agricultural Lands designation, such that any determination on our part could be premature. As stated earlier, HDOA suggests that a reason there may have been few applicants for the credit is that only one county – the City and County of Honolulu – has formally submitted plans and maps identifying potential Important Agricultural Lands for approval. If other counties obtain Important Agricultural Lands designations from the Land Use Commission, the credit may see higher use. In short, use of the credit appears at least partially obstructed by lack of Important Agricultural Lands designations, such that the credit has not been able to perform enough to be properly assessed.

Income Tax Credit for a Qualified Business in an Enterprise Zone (Section 209E-10, HRS)

THIS CREDIT was enacted as a part of Act 78, SLH 1986, in which the Legislature asserted that there were certain areas in the State needing particular attention of government to help attract private-sector investment. These areas, or "Enterprise Zones," are meant to be major economic development tools to help bring business and employment opportunities to otherwise economically challenged areas.

Eligible businesses located within an Enterprise Zone that meet hiring requirements are exempt from GET and may claim personal or corporate non-refundable income tax and state unemployment premium credits, among other benefits. Counties can also offer additional incentives, such as incremental property tax relief, priority permit processing, or fee waivers.

Tax Credit at a Glance (2020)

Amount claimed	Number of Claims	Tax Expenditure	Cost Per Low-Income Resident	Meeting its Purpose?
$700,000	42	$700,000	$1.46*	Unable to Determine

*Cost per low-income resident used is the amount claimed per year divided by a low-income resident figure of 480,801 derived from Department of Business, Economic Development and Tourism data.

Relevant Legislative History

Section 209E-10

1986
Act 78, SLH 1986, enacted the credit

1989
Act 390, SLH 1989, clarified terminology and eligibility criteria

2009
Act 174, SLH 2009, further clarified eligibility criteria and extended the credit for 7 years

What does this tax credit do?

The Enterprise Zone tax credit provides qualified businesses an income tax credit of 80 percent of the income tax due to the State for the first year. The credit decreases 10 percent each year for another six years. A qualified business that manufactures tangible personal property or produces or processes agricultural products can claim the credit for an additional three years at the rate of 20 percent for each year. A "qualified business" is one that begins its operation in an Enterprise Zone, realizes at least 50 percent of its gross receipts from that Enterprise Zone or other Enterprise Zones in the same county, and increases either its number of employees or agricultural sales by a certain percentage over certain periods. If the business seeks to qualify by employee increase, it must increase the number of its employees by at least ten percent during the business's first year and maintain that new minimum level of employment thereafter. If the business seeks to qualify by agricultural sales, it must increase its gross sales of agricultural products processed in those Enterprise Zones by two percent annually. Every qualified business must also be a corporation, partnership, limited liability company, or sole proprietorship authorized to do business in Hawai‘i and subject to Hawai‘i corporate or individual income tax, and engaged in an eligible business activity. In the case of a partnership, each partner may claim the credit in proportion to the amount of income received by the partner from the partnership.

Eligible business activities include (1) manufacture of tangible personal property, the wholesale sale of tangible personal property, or a service business; (2) production of agricultural products where the business is a producer, or the processing of agricultural products, all or some of which were grown within an Enterprise Zone; (3) research, development, sale, or production of all types of genetically-engineered medical, agricultural, or maritime biotechnology products; and (4) production of electric power from wind energy for sale primarily to a public utility company for resale to the public.

Qualified businesses may also claim an income tax credit of 80 percent of unemployment taxes paid for all employees employed in the Enterprise Zone for the first year. That credit goes down 10 percent each year for the following six years. In the case of a qualified business manufacturing tangible personal property or producing or processing agricultural products, the business may claim the credit for an additional three years beyond those first seven at the rate of 20 percent per year. This credit is not refundable and any unused credit may not be carried forward to future tax years. Under Section 209E-9(c), HRS, each qualified business in an Enterprise Zone shall submit annually to the Hawai‘i Department of Business, Economic Development and Tourism (DBEDT) information necessary for the department to certify the tax credits and exemptions sought by each business. Section 209E, HRS, tax credit claims must be accompanied with a copy of DBEDT’s certification.

How does this tax credit work?

Claiming this credit is a multistep process. First, the prospective claimant must submit an Enrollment Application For Business, which is completed online at eHawaii.gov. If a reporting company meets the requirements of the program, DBEDT issues a letter of “Certification.” If DBEDT grants Certification, the business then completes the DOTAX form for the Enterprise Zone Tax Credit, Form N-756. Completion of that form yields a credit amount, which the taxpayer enters on Schedule CR. That amount is aggregated with other nonrefundable credits, and the taxpayer enters the sum of refundable credits on the relevant income tax return. For example, for a Hawai‘i resident corporation, the credit would be couched in the total for all nonrefundable tax credits from Schedule CR on Form N-30, line 14. On the return, the credit acts as a negative against income tax, reducing the balance due to the State.

The company must also file an end-of-year report for each year for which it intends to claim the credit. If a company does not file an end-of-year report with DBEDT, then it may not claim any GET exemption or nonrefundable income tax credit for that tax year, including any Enterprise Zone tax credit.

What is the purpose of this tax credit?

The purpose of the Enterprise Zone program was to stimulate business and industrial growth in areas where such would result in neighborhood revitalization. Such growth was to be accomplished by regulatory flexibility and tax incentives, with this credit as part of the incentives provided under the program.

Is the tax credit meeting its purpose?

We cannot determine from data available whether the income tax credit for a qualified business in an Enterprise Zone is meeting its purpose. Section 209E-3, HRS, states that DBEDT shall have powers and duties that include submitting annual reports evaluating the effectiveness of the program and any recommendations for legislation to the governor. We reviewed the DBEDT report for tax year 2020 and noted that, in that year, DBEDT-certified companies reported 1,095 new or maintained jobs statewide, which was down from the 1,659 reported in 2019. However, the DBEDT report does not evaluate the extent to which jobs created and maintained impacted the economic vitality of their surrounding Enterprise Zone. Therefore, it is unclear from the DBEDT reports the extent to which the tax credits actually stimulated business and industrial growth in areas resulting in neighborhood revitalization of those areas as envisioned under the program's purpose. In short, we cannot deduce causation from the correlation of the credit and economic improvement. We note that it is not clear how DBEDT should evaluate the program's effectiveness because there are no performance benchmarks for the Enterprise Zone tax credits established in Section 209E-10, HRS.

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

Year	2018	2019	2020
Number of Claims	73	58	42
Tax Credits Claimed	$1,100,000	$1,300,000	$700,000

Source: DOTAX 2018, 2019, and 2020 *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 tax credit?

A DBEDT report from 2020 shows that Enterprise Zone companies claiming the credit have created or maintained jobs, but we cannot determine to what extent there is or is not a causal connection between such job creation and the credit. According to the report, Enterprise Zone companies reported creating or maintaining 1,659 jobs in 2019. Forgone revenue from Enterprise Zones income tax credits for the same year totaled $1.3 million. Therefore, cost of the income tax credit to the State, in 2019, was $783 per job. DBEDT stated the cost per job of the income tax credit and a related GET exemption, combined, has been fairly consistent in past years, never exceeding $2,000. However, we cannot be certain from the DBEDT report that the reason, or even a reason, behind the job growth and steady job statistics is the tax credit. The DBEDT report contains no analysis showing any correlation or causation between the credit and the economic health of the Enterprise Zones, and drawing a conclusion pertaining to such correlation or causation would be speculative. For example, there is no way to discern from the report between those Enterprise Zone companies that maintained or generated jobs out of a motivation to claim the credit and those Enterprise Zone companies that would have maintained or generated jobs regardless of any credit..

We note that the credit appears to be underutilized, insofar as there are many companies qualified as Enterprise Zone companies that are not claiming the credit. The total number of companies enrolled in DBEDT’s Enterprise Zone Program statewide in 2020 was 191, but only 55 companies filed annual end-of-year reports required to claim state tax credits. Only 42 companies actually claimed the credit. In its 2020 report, DBEDT noted that it is trying to improve program tracking by encouraging Enterprise Zone companies to submit their end-of-year reports, regardless of whether they have met tax incentive requirements. With the majority of qualified companies having exhausted or not claiming the credit, we question to what extent the credit remains a motivating factor.

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

We lack sufficient relevant data and analysis to support a determination of whether the tax credit should be retained, amended, or repealed. Enterprise Zone job growth and maintenance have increased and stabilized, but we cannot determine whether that is due to the credit or another cause. Most companies qualifying for the credit do not claim it, but the remainder that do claim it may or may not be motivated by the credit. We do not have sufficient relevant data to identify taxpayer motivations.

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
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

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

Report Date	HRS Ref.	Statute to be reviewed	Notes
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

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, also requires us to estimate the "annual cost of the credit, exclusion, or deduction 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 480,801 "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 Provisions per "Low-Income Resident"

Statute	Tax Provision	Cost	Cost per "low-income resident"
Section 235-110.6, HRS	Tax Credit for Fuel Taxes Paid by a Commercial Fisher	$429,000	82 cents
Section 209E-10, HRS	Income Tax Credit for a Qualified Business in an Enterprise Zone	$700,000	$1.46

Source: Office of the Auditor

The following table contrasts GET data with Hawai‘i's total 2020 population of 1,407,006 people. The results of this evaluation follow and only include the Auditor's tax expenditure estimate for the tax provisions with reportable data.

Cost of Tax Provisions per Hawai‘i Resident

Statute	Tax Provision	Cost	Cost per Hawai‘i resident
Section 235-110.6, HRS	Tax Credit for Fuel Taxes Paid by a Commercial Fisher	$429,000	30 cents
Section 209E-10, HRS	Income Tax Credit for a Qualified Business in an Enterprise Zone	$700,000	50 cents

Source: Office of the Auditor