LATE TESTIMONY

From: Ray Kamikawa [rkamikawa@ckdbw.com]
Sent: Thursday, January 28, 2010 9:12 PM
To: Roz Baker; Rep. Isaac W. Choy; Rep. Angus McKelvey; Sen. Carol Fukunaga
Cc: Rep. Gene Ward; Warren Haruki; Cheryl Walthall <cwalthall@prp-hawaii.com
Subject: Hotel Tax Credits -- historical data by DOTAX 10-20-2009, etc.
Attachments: Hotel Tax Credits (historical) by DOTAX 10-20-2009.pdf; Ray Kamikawa.vcf

To all,

Thank you again for the opportunity to present the SCR 132 task force tax committee's proposals.

At the briefing this morning, the committees requested information on historical data on the previous hotel and renovation tax credit. Please find attached the historical data compiled by DOTAX on certain tax credits, including the hotel tax credits. Also attached is an analysis by Professor Jim Mak on the impact of the hotel tax credits (conclusion was that the credits substantially increased construction).

Other questions posed by the committees will be answered in due course.

Thank you.

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LATE TESTIMONY

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October 20, 2009

The Honorable Colleen Hanabusa
Senate President
State Capitol Suite 409
Honolulu Hawaii 96813

RE: COST DATA FOR CERTAIN TAX CREDITS

Dear Senate President Hanabusa:

This responds to your letter dated September 30, 2009, requesting data for the hotel construction and remodeling tax credit, the residential construction and remodeling tax credit, the low income housing tax credit, and the renewable energy system tax credit.

The attached Tables 1 to 4 provide data for each of these tax credits by tax year, the number of tax returns that claimed each of these tax credits, the annual total cost of the credits, and the cumulative cost of each tax credit for all of the applicable tax years requested. We do not have the data regarding the breakdown of taxpayers by individual or by type of entity readily available.

Please note that the hotel construction and remodeling tax credit was originally a 4% refundable tax credit effective January 1, 1999, that sunseted on December 31, 2005. However, the credit was modified by Act 10, SLH 2001, to be a 10% non-refundable credit for costs incurred after November 2, 2001 and before July 1, 2003. The non-refundable credit can only be used against actual tax liability, and any excess can be carried over indefinitely until exhausted.

If you have questions regarding these data or if you need any additional information, please feel free to call me at (808) 587-1513 or my cell at (808) 258-3383.

Very truly yours,

KURT KAWAFUCHI
Director of Taxation

Table 1
Hotel construction and remodeling tax credit: 1999 to 2006

Year	No. of returns	Annual cost ($million)	Cumulative cost ($million)
1999	21	1.2	1.2
2000	127	7.1	8.3
2001	201	7.4	15.7
2002	147	3.7	19.4
2003	261	5.3	24.7
2004	292	12.7	37.4
2005	216	15.3	52.7
2006	26	0.6	53.3

Table 2.
Residential construction and remodeling tax credit: 2001-2006

Year	No. of returns	Annual cost ($million)	Cumulative cost ($million)
2001	8,778	11.3	11.3
2002	17,481	13.4	24.7
2003	12,726	13.1	37.8
2004	2,081	5.1	42.9
2005	867	7.8	50.7
2006	516	7.9	58.6

Table 3.
Low Income Housing Tax Credit: 2002-2006

Year	No. of returns	Annual cost ($million)	Cumulative cost ($million)
2002	42	3.0	3.0
2003	45	2.1	5.1
2004	34	2.2	7.3
2005	39	5.9	13.2
2006	32	6.5	19.7

Table 4.
Renewable energy system tax credit: 2003 to 2006

Year	No. of returns	Annual cost ($million)	Cumulative cost ($million)
2003	3,272	5.4	5.4
2004	1,884	2.2	7.6
2005	2,280	2.6	10.2
2006	3,954	6.2	16.4

Analysis of Hawaii's Hotel Construction and Remodeling Tax Credits

James Mak, Ph.D.

Act 10, Third Special Session Laws of Hawaii 2001, temporarily increased the Hotel Credit from a refundable 4 % credit to a nonrefundable 10% credit for costs incurred on or after November 2, 2001 through June 30, 2003. The changes to the credit will be repealed on June 30, 2003. For costs incurred after June 30, 2003, the credit will revert to the original refundable 4% credit and continue until December 31, 2005.

HB1400 makes the following changes to the Hotel Credit:

1. Extends the 10% Hotel Credit for costs incurred before July 1, 2008 (the current sunset date is July 1, 2003).
2. Changes the 10% Hotel Credit from a nonrefundable credit to a refundable credit. The credit never reverts to the 4% credit.
3. Amends the definition of "qualified hotel facility" to include commercial buildings and facilities located within a "qualified resort area" and adds a definition of "qualified resort area".

This report (1) attempts to ascertain whether tax incentives have induced an increase in hotel construction and remodeling expenditures since they were first legislated into law by the Hawaii Legislature in 1997; and (2) to evaluate the Department of Taxation's estimate of potential tax revenue loss from HB1400.

Brief History of Hawaii Hotel Tax Credits

The history of Hawaii's hotel credits is summarized in the Department of Taxation's *Annual Tax Credit Report to the Governor*. Hawaii's hotel tax credit history began in 1997 when the Legislature passed Act 108 which provided an income tax credit of up to 4% of renovation cost for each qualified hotel facility located in Hawaii, with the amount of the tax credit capped at 10% of the transient accommodation tax (TAT) paid by the taxpayer in the preceding year.

In 1999, the Legislature passed Act 306 which removed the TAT cap and hence made the hotel tax credit more valuable to hotel operators. The tax credit can be applied to the general excise tax (GET), income tax, public service company tax (PSC), or the TAT.

In 2000, the Legislature passed Act 195 granting a 4% refundable credit for hotel construction and renovation costs for taxable years beginning after December 31, 1998 and before January 1, 2003.

Following the September 11, 2001 terrorist attacks, the Legislature enacted Act 10 which converted the 4% refundable hotel construction and renovation tax credit to a 10% non-refundable credit for qualifying expenditures incurred before July 1, 2003; thereafter the credit reverts to the 4% refundable credit.

Impact of Hotel Tax Credits

Table 1 summarizes the number of hotel tax credit claims and their dollar amounts for taxable years, 1997-2001. The figures for 2001 are still preliminary.

Table 1
Hotel Tax Credits Claimed, 1997-2001

Tax	Number Claimed			Dollar Amount		
Year	Individuals	Corporations	Total	Individuals	Corporations	Total
1997	20	36	56	$ 35,000	$ 894,000	$ 929,000
1998	49	69	118	135,000	1,675,000	1,810,000
1999	--	21	21	--	1,174,000	1,174,000
2000	66	61	127	1,000,000	6,100,000	7,100,000
2001	N.A.	N.A.	259	N.A.	N.A.	7,400,000

Source: Department of Taxation.

It should be noted that for the years between 1997 and 2000, though the rate was the same at 4%, because there was a cap on the amount of tax credit refundable before 1999 the amounts for 1997 and 1998 are not comparable to the dollar amounts for 1999 and 2000. However, the number of tax credits claimed should be comparable for all 4 years; that is, everyone who qualified for a credit will have filed, but before 1999, the amount that could be claimed was capped at 10% of the TAT paid in the preceding year. For 2001, the tax credit changed from a 4% refundable credit to a 10% non-refundable credit for expenditures incurred after November, 2001.

For 1999 and 2000, we can conveniently use the dollar amounts of the Hotel Credit to estimate the amount of hotel construction and renovation spending by dividing the amounts by .04. For 1999, the implied amount of construction and remodeling spending was $29 million; for 2000, it was nearly $178 million (Table 2). The lion's share of the construction spending in tax year 2000 (95% of the dollar amount and 70% of the claims) occurred on Oahu. The Department of Taxation noted that there was "a big jump" in the amount of tax credits granted in tax year 2000 over 1999, implying that there was a big jump in the amount of construction and renovation spending in 2000 over 1999. Hotel construction and renovation spending increased by more than 500% between 1999 and 2000, compared to roughly a 20% increase for all construction spending in Hawaii (as measured by the excise tax base for contracting) during the same period.

Preliminary figures provided by the Department of Taxation for tax year 2001 indicate that 259 claims were made for the Hotel Credit for a total amount of $7.4 million. A breakdown of the claims shows that 196 of the claims (totaling $5.7 million) were made under the 4% refundable credit, and 63 (totaling $1.65 million) were made under the non-refundable 10% tax credit. The implied amount of construction and remodeling spending was <u>at least</u> $159 million. Why "at least"? Because the 10% nonrefundable credit is applicable only to taxable income; a hotel that has no taxable income cannot get a refund for that year even if it incurred actual construction and remodeling expenses in that taxable year; it can claim any excess credits in future years when the hotel returns to profitability.

For 2001, the average value per claim under the 4% refundable credit was $29,082, while the average per claim under the 10% non-refundable credit was $26,190. The amount per claim under the 10% credit was much smaller! The gap widens when we convert the claims to equivalent dollar values of construction expenditures; they were respectively $727,040 per claim under the 4% credit and $261,905 under the 10% credit. Given that it takes time to plan and actually put construction in place, it is reasonable to assume that the amounts claimed under the 10% credit represent construction plans already in progress before the 10% credit was passed in October, 2001. It is highly likely that the profit constraint (following the September 11 terrorist attacks) imposed a cap on the size of the refunds. For taxable year 2001, there was another big jump in the number of claims (from 127 in 2000 to 259 in 2001), and a slight increase in the total dollar amounts claimed (from $7.1 million to $7.4 million), but a substantial decrease in the dollar value per claim under the 10% tax credit.

Again, given the planning and construction lags involved, it is also apparent that the impact of any new tax credit law is delayed at least until the following tax year (i.e. after the bill is enacted into law). This means that the full impact of removing the cap on the 4% tax credit in 1999 did not show up until 2000 or later, and the full impact of the 10% nonrefundable tax credit would not show up until 2002 or later. In sum, while the Legislature intended Act 10 to stimulate hotel construction and renovation, the incentive only had a window of not much more than 1 year.

Table 1 further shows that both individuals and corporations filed for the Hotel Credits, but the bulk of the credits (in dollars) went to corporations rather than to individuals. Moreover, as Table 2 shows, the dollar amount of tax credits granted per claimant also rose sharply for both individual and corporations.

Table 2

Amount Per Claim and Total Qualifying Construction Expenditures

Tax Year	Dollar Amt./Claim: Individual	Dollar Amt./Claim: Corporation	Total Construction Spending Implied
1997	$ 1,750	$ 24,833	at least $23.2 Mil.
1998	2,755	24,275	at least $45.3 "
1999	--	55,905	29.4 "
2000	15,152	100,000	177.5 "
2001			at least 159.0 "

Hotel tax credits are not the only factor that motivates hotel renovation and construction. *Nonetheless, all things considered, the figures in Tables 1 and 2 strongly suggest that the hotel tax credits passed by the Legislature did substantially increase the volume of hotel construction and renovation activities.* This was what the Legislature had intended. Tax credit laws with sunset dates are intended to induce investors to increase their investment spending in a specific time period. This did occur in Hawaii with the hotel tax credits, although the window of opportunity was very short under Act 10 and the data are still not available to evaluate its effects. Nonetheless, in reviewing the entire Hotel Credit history since 1997, both the number of applicants rose dramatically after 1999 following the removal of the tax credit cap, and the dollar amount of renovations per applicant also rose dramatically. How much more construction activity was induced by the hotel tax credits is difficult to ascertain precisely given the limited amount of data available and the fact that other factors may also have contributed to construction expenditure decisions. Nonetheless, interviews conducted by Hospitality Advisors, as summarized earlier, confirm that the availability of a tax credit contributed significantly to the applicant's investment decisions.

HB1400 seeks to extend the tax credit deadline to June 30, 2008, convert the 10% non-refundable credit to refundable, and enlarge the scope of coverage to include other commercial properties in qualified resort areas. Because "time is money", the refundable provision of HB1400 makes the 10% tax credit worth more to the investor than the nonrefundable 10% tax credit (Act 10). Thus, it should encourage investors to undertake even more construction and renovation activity before the sunset date.

Tax Revenue Implications of HB1400

The Department of Taxation estimates (February 11, 2003 testimony to the Senate Committee on Tourism and the Senate Committee on Economic Development) that based on its projections of hotel renovations and DBEDT's projections of additional hotel units to be built, total improvement costs in hotel facilities would be $328.8 million per year. Thus, a tax credit of 10% would lower tax revenue by $32.9 million annually. An additional $6.3 million in tax credits per year (from $63 million in annual commercial construction spending) could be claimed for construction and renovation of commercial buildings and facilities located within designated "qualified resort areas". Thus, the Department of Taxation estimates "total tax revenue loss [from HB1400] would amount to $39.2 million".

The Department of Taxation's estimate of $39.2 million of total tax revenue loss from HB1400, however, tells an incomplete story. While the Department's records may show under the column Hotel Credits a revenue loss of $39.2 million, that amount only represents a "gross" loss and not a "net" loss in tax revenues. Construction spending in the state generates business activity, household earnings, jobs and employment, as well as tax revenues. If the tax credit stimulates additional construction spending, the additional tax revenues generated by the increased economic activity in the state offsets the credits given.

To illustrate, assume that the Department of Taxation forecast is correct that there will be $328.8 million in hotel construction and renovation spending per year between July 1, 2003 and June 30, 2008, and $63 million annual spending in other commercial construction and renovation spending in qualified resort areas. Applying DBEDT's relevant economic multipliers (DBEDT, *The Hawaii Input-Output Study, 1997 Benchmarks*, March, 2002) to the hotel and commercial construction spending estimated by the Department of Taxation yields the following annual total economic impacts:

	Business Activity (Sales)	Earnings	Jobs*	State Tax Revenues
Hotel Construction ($328.8 Mil.)	$677 Mil.	$217 Mil.	6,083	$37.8 Mil.
Other Commercial ($63 Mil.)	130	42	1,210	7.4.
Total	$ 807 Mil.	$259 Mil.	7,293	$45.2 Mil.

Note: *Using 2003 "total jobs" multipliers. If we used the 2007 job multipliers, the number of jobs created falls to 6,900.
Source: DBEDT, *The Hawaii Input-Output Study, 1997, Benchmark Report* (March, 2002), Spreadsheets: Detailed Tables accessible at hawaii.gov/dbedt/97io/97io-d.xls

The $391.8 million in construction spending generates $45.2 million in total state tax revenues; a 10% tax credit on that amount of construction spending gives back $39.2 million in tax revenues. The amount of tax revenues given back is less than the total amount generated. Since these are "benchmark" estimates, one should regard these numbers as "ballpark" rather than precise figures.

In what way does the $39.2 million given back in tax credits represent a net loss in state tax revenues? One might argue that the $391.8 million in construction spending would have occurred anyway; thus the entire $39.2 million in tax credits is just a give-away. This assumes that HB1400 would not induce any additional construction activity. But the analysis above strongly suggests that Hawaii's hotel tax credits have induced significantly more construction spending in the state in the 1997-2001 period. Suppose 50% of the $392 million (or, $196 million) predicted construction activity is attributable to HB 1400; this would generate an additional $22.5 million in state tax collections, using DBEDT's economic multipliers. The state returns $39.2 million in credits to taxpayers for $392 million of qualifying hotel and commercial construction expenditures, resulting in a net loss in tax revenues of $16.7 million. That number would be whittled down further if renovations produce increases in room rates and higher spending visitors as documented by Hospitality Advisors. In exchange for the $16.7 million in lost tax revenues, Hawaii gains $400 million in additional business activity (sales), nearly $130 million in additional earnings, 3,646 additional jobs annually during this period, and a higher quality visitor plant. The average annual cost to the State treasury of 1 job created is about $4,500.

The 50% assumption may be on the low side. Table 2 suggests that the increase in hotel construction and remodeling activity induced by Hawaii's hotel credits may be as high as 75%. The following shows the potential impacts of HB1400 on net state tax revenues assuming 50%, 67%, and 75% respectively of DoTax's construction spending estimates are induced by HB1400:

Construction Due to HB1400	Additional Tax Revenues	Tax Credit Granted	Net Tax Revenues
50%	$22.5 Mil.	$39.2 Mil.	-$16.7 Mil.
67	30.2	39.2	- 9.0
75	33.9	39.2	- 5.3

Thus, if 75 percent of the DoTax's predicted construction activity is attributable to the HB1400, the net loss in tax revenues falls to $5.3 million, and the cost per job created falls to less than $1,000. As mentioned earlier, the $5.3 million figure is eventually erased if renovation expenditures enable hotels to raise their room rates and attract higher spending visitors.