STATE OF HAWAI'I
OFFICE OF THE AUDITOR
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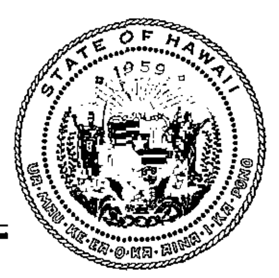

LESLIE H. KONDO
State Auditor

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November 22, 2016

DEPT. COMM. NO. 24

VIA HAND DELIVERY

The Honorable Ronald D. Kouchi
President of the Senate
Hawai'i State Capitol, Room 409
Honolulu, Hawai'i 96813

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

Dear President Kouchi:

We have completed our audit of Hawai'i's Motion Picture, Digital Media, and Film Production Income Tax Credit. We found the Department of Taxation's and the Hawai'i Film Office's administration of the film tax credit to be insufficient and to have likely increased the cost of the credit while overstating the possible economic benefits that it provides the State.

We are enclosing a copy of our audit report, Report No. 16-08. The report is accessible through the Office of the Auditor's website at http://files.hawaii.gov/auditor/Reports/2016/16-08.pdf.

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

Very truly yours,

Leslie H. Kondo
State Auditor

LHK:ly

c: Legislative Reference Bureau Library
Ben Villaflor, Senate Sergeant-At-Arms
Carol T. Taniguchi, Senate Chief Clerk

Enclosure

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

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

Report No. 16-08
November 2016

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 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:
http://auditor.hawaii.gov

Foreword

Our audit of Hawai‘i’s Motion Picture, Digital Media, and Film Production Income Tax Credit was conducted pursuant to article VII, section 10, of the Hawai‘i State Constitution and section 23-4, Hawai‘i Revised Statutes, which require the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

We thank the Department of Taxation; the Department of Business, Economic Development, and Tourism; the Hawai‘i Film Office; and other individuals whom we contacted during the course of our audit for their cooperation and assistance.

Leslie H. Kondo
State Auditor

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Auditor's Summary

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

Report No. 16-08

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

What problems did the audit work identify?

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

Why did these problems occur?

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

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

Tax credits: tools for economic development

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

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

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

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

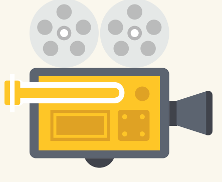
We also found that the film office's analysis of film tax credit data does not measure the incentive's true costs and reports economic impacts that are based on incomplete and overstated data. For instance, it includes an unknown amount of out-of-state expenditures and wages paid to non-residents, as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

20/25

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

Why do these problems matter?

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



Starring Roles

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

Chapter 1

Overview of Hawai‘i’s Film Tax Credit

WHILE HOLLYWOOD is considered the home of feature films and major television shows produced by U.S. companies, locations outside of California have become significant film production centers in recent years. For example, Louisiana hosted more major feature films released in 2013 than any other location on earth. Hawai‘i and other jurisdictions are increasingly using tax incentives as economic development tools to lure in film and television productions. As of 2014, 39 states and Puerto Rico had film production incentives on their books, compared with just a handful that provided such incentives in the early 2000s.[1] Film and television productions are targeted because they generate crew wages and other expenditures that directly benefit local vendors and suppliers. The production money also circulates within local economies, providing indirect benefits to residents and businesses unaffiliated with the production.

Tax credits: tools for economic development

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

Tax credits, however, are much less transparent than direct expenditures because they are not part of a state’s budget and are not appropriated by the legislature. As a result, tax credits are much less likely than other government spending to be analyzed, debated, and weighed against other priorities.

Legislative history of Hawai‘i’s motion picture, digital media, and film production income tax credit

Hawai‘i’s income tax credit for motion picture and television production costs was created in 1997 through Act 107, Session Laws of Hawai‘i (SLH) 1997. Film and television productions were entitled to a tax credit of up to 4 percent of production costs incurred in the State, and 6 percent of the expenditures for transient accommodations. In 1999, the credit increased from 6 percent to 7.25 percent of actual expenditures for transient accommodations. Act 88, SLH 2006, significantly increased the tax credit—to 15 percent of eligible O‘ahu production expenditures and 20 percent of eligible neighbor island production expenditures—and renamed it the motion picture, digital media, and film production income tax credit. The purpose of the tax credit, which is set to sunset at the end of December 2018, is to encourage the industry to hire local residents and to support training and educational initiatives and opportunities. More specifically, the Legislature intended that the tax credit would: (1) provide enhanced incentives that attract more film and television productions to Hawai‘i, thereby generating tax revenues; (2) generate jobs and income for residents; (3) support tourism and the natural beauty of Hawai‘i; and (4) enable Hawai‘i to effectively compete for productions against other jurisdictions that offer similar incentives.

[1] National Conference of State Legislatures, *State Film Production Incentives & Programs*, May 2014, p.1.

In 2013, the Legislature increased the tax credit by another 5 percentage points for production expenditures incurred on O'ahu and the neighbor islands. Act 89, SLH 2013, also requires the Department of Business, Economic Development and Tourism (DBEDT), which administers the credit through the Film Industry Branch, also known as the Hawai'i Film Office (film office), to submit an annual report to the Legislature detailing the non-aggregated qualified production costs.[2] The film office also must provide the Legislature, annually, with a cost-benefit analysis of the tax credit.[3]

The film tax credit law

Hawai'i's film tax credit is codified in section 235-17, Hawai'i Revised Statutes (HRS), as part of Hawai'i's income tax law. The film tax credit is based on a production company's expenditures while producing a qualified film, television, commercial, or digital media project in Hawai'i. Although there is no total annual statewide spending cap for the film tax credit, there is an annual limit for the amount of tax credit that each production can claim. As of 2013, the maximum amount of tax credits that a production can claim is $15 million per project per tax year,[4] and the credits must be claimed within 12 months following the close of a taxable year.

Qualified productions include motion pictures, television shows, music videos, interactive games, and commercials with expenditures in Hawai'i. News, sporting events, and pornography do not qualify for the credit. To be eligible for the film tax credit, a qualified production must:[5]

- Have qualified production costs totaling at least $200,000;
- Provide the State, at a minimum, a shared-card, end-title screen credit, where applicable;
- Provide evidence of reasonable efforts to hire local talent and crew; and
- Provide evidence of financial or in-kind contributions or educational or workforce development efforts in partnership with related local industry labor organizations, educational institutions, or both, toward the furtherance of the local film and television and digital media industries.

[2] The film office is required to protect a production's confidentiality by redacting information that can reasonably identify the production.
[3] Act 89, SLH 2013.
[4] Only one entity per project may claim the tax credit. *DoTAX Tax Information Release No. 2009-05*.
[5] Section 235-17(c) and (l), HRS.

Hawai‘i’s film tax credit compared to similar incentives offered by other jurisdictions

Hawai‘i’s film tax credit is roughly in the middle tier of the film production-related incentives by one measure: the percentage of the incentive. Hawai‘i’s film tax credit of 20 to 25 percent of qualified production costs is the same as California, more than Nevada, and slightly less than Louisiana and New York, for example. However, while most states have an annual total funding or program cap, Hawai‘i has no cap. Also, while some states prohibit or limit incentives to support wages and salaries paid to non-residents, Hawai‘i allows productions to include all of the compensation of non-resident cast and crew earned for work performed in the State as expenditures eligible for the tax credit. Exhibit 1.1 shows the range of incentives for film productions in selected states.

Exhibit 1.1
Comparison of Selected States’ Film Production Incentives

State	Incentive %*	Total Funding or Program Cap	Incentive Type
California	20 or 25	$330 million	Tax Credit
Georgia	20 or 30	No cap	Tax Credit
Hawai‘i	**20 or 25**	**No cap**	**Tax Credit**
Louisiana	30 or 35	$180 million	Tax Credit
New Mexico	25 or 30	$50 million	Tax Credit
New York	30 or 40	$395 million	Tax Credit
Tennessee	25	$2 million	Grant
Texas	5-22.5	$32 million	Grant

Source: Office of the Legislative Auditor, State of Minnesota, *Minnesota Film & TV Board Evaluation Report*, April 2015; Cast & Crew Financial Services, *The Incentives Program*, Fall 2016

*Note: This covers a range of reimbursement rates because many states have different reimbursement rates based on higher minimum spending amounts, resident wages, or spending that occurs in different regions of the state.

Administration and implementation of the film tax credit

Both the Department of Taxation (DoTAX) and DBEDT, through the film office, are involved with the administration and implementation of the film tax credit.

DoTAX’s film tax credit responsibilities include adopting administrative rules to implement the film tax credit, reporting on tax credits claimed by Hawai‘i taxpayers, conducting taxpayer audits, and disbursing unused tax credits in the form of refunds.

The film office

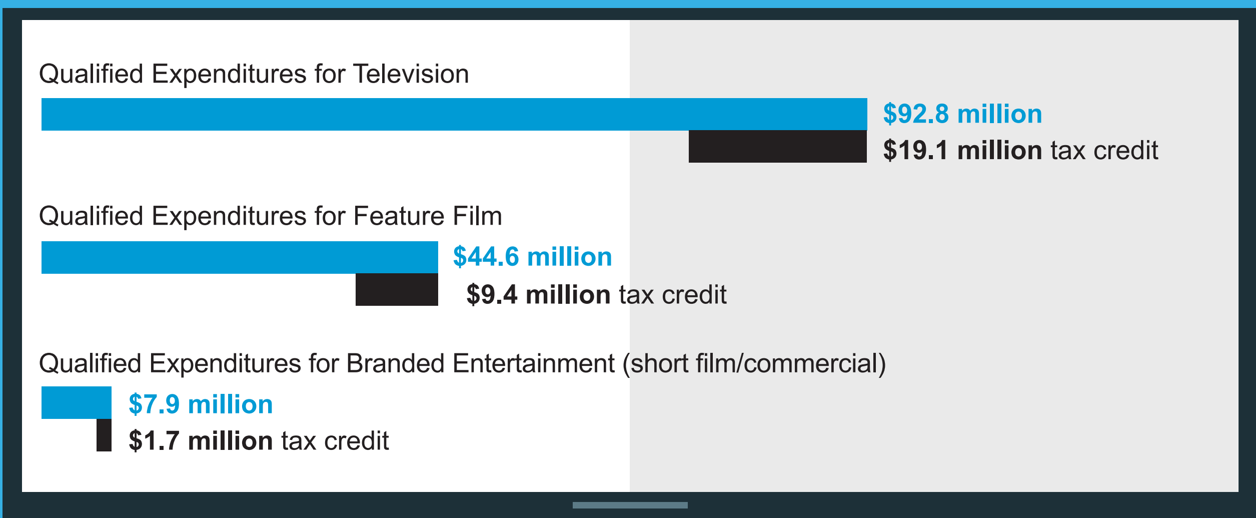
The film office, which is part of the Creative Industries Division, promotes and advocates for Hawai‘i’s film and television production industry. The film office was established within DBEDT in 1978 to recognize the increasing importance and potential of the film industry and serves as a liaison between the State and the industry by providing information and services to filmmakers. It also operates the Hawai‘i Film Studio, manages the film tax credit in conjunction with DoTAX, and oversees the film industry permit application center, which is the central coordinating entity for processing film permits for the use of State lands and properties.

The film office prequalifies productions for the film tax credit based on information contained in a production registration form that a production company must submit at least one week before its first Hawai’i shoot date. Upon project completion, the production company must submit a Hawai‘i production report to the film office. The film office reviews the production’s reported expenditures, then issues a certification letter, which the taxpayer submits with its tax forms to DoTAX. Additionally, the film office, with the support of the DBEDT’s Research and Economic Analysis Division, is responsible for submitting an annual report to the Legislature.

In 2015, the film office certified that 35 productions qualified for the tax credit. On average, there were 37 qualified productions for years 2013–2015. Exhibit 1.2 shows the qualified expenditures and tax credits certified by the film office during 2014 by production type.

In 2014, the $145.2 million in production expenditures that qualified for the tax credit, as shown in Exhibit 1.2, would have generated approximately $17.4 million in Hawai‘i income tax and general excise tax (GET) revenue. Assuming that the entire $30.1 million in tax credits certified in 2014 were claimed with DoTAX, the State would have paid out $12.7 million more in tax credits than the tax revenue created by qualified production spending.

Exhibit 1.2
Qualified Expenditures and Film Tax Credits Certified by Production Type for 2014



Source: Hawai'i Film Office production certification letters

Top Film Tax Credit Claimants in 2014

1. **$52 million**
(Television production)
$10.4 million tax credit

2. **$40.5 million**
(Feature film production)
$8.5 million tax credit

3. **$26.8 million**
(Television production)
$5.4 million tax credit

4. **$6.2 million**
(Television production)
$1.6 million tax credit

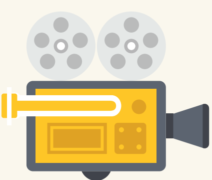
5. **$2.8 million**
(Feature film production)
$565,678 tax credit

Film tax credit costs

The film tax credit cost the State about $31.9 million in 2013 compared to $12.7 million in 2012, when the total film tax credit allowed for a single qualified production was capped at $8 million. Exhibit 1.3 shows the number of income tax returns that claimed the film tax credit and the total amount claimed for years 2011–2013, which was the most recent data available.

Audit Scope and Methodology

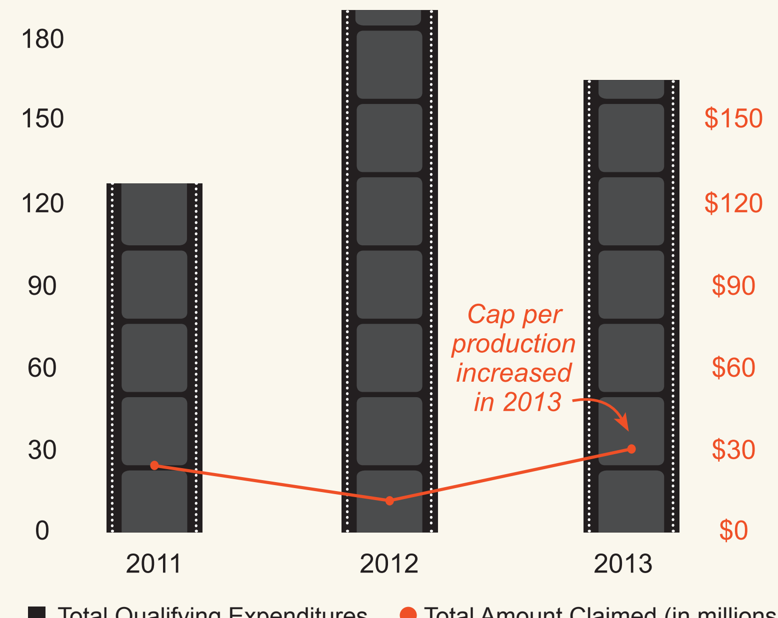
We conducted this performance audit of the film tax credit pursuant to article VII, section 10 of the Hawai'i State Constitution and section 23-4, HRS, which authorizes the Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions. This is our first audit of the film tax credit.



Despite the cap per production being raised in 2013, the total amount claimed did not increase substantially.

Exhibit 1.3

Film Tax Credits Claimed by Hawai'i Taxpayers for Tax Years 2011–2013



Tax Year	Production Cap	Total Qualifying Expenditures	Total Amount Claimed
2011	$8 million	$127.7	$25.7 million
2012	$8 million	$189.1	$12.7 million
2013	$15 million	$163.8	$31.9 million

Source: Department of Taxation, Hawai'i Creative Industries Report 2015

Our audit was performed from November 2015 through May 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained meets these standards for providing a reasonable basis for our findings and conclusions in this report.

To achieve our audit objectives, we reviewed legislation relevant to the State's film tax credit, DoTAX's proposed administrative rules, budgets, performance measures, various DBEDT and DoTAX reports, and other key documents. We also interviewed personnel within the Creative Industries Division (CID), the film office, and DoTAX who are involved with the credit's planning and implementation.

In addition, we reviewed the film office's policies and procedures for administering the credit, information provided by the film office to taxpayers, forms required to be submitted by productions during the registration and certification processes, the film office's annual reports to the Legislature, and other supporting documents. We further interviewed key personnel within CID, the film office, DoTAX, and DBEDT's Research and Economic Analysis Division, who have roles in administering and reporting on the tax credit.

As part of the work described above, we reviewed the legal requirements of other selected states' film prodcution incentives and identified best practices issued by the U.S. Government Accountability Office in its *Standards for Internal Control in the Federal Government*. We compared the results of our work performed against these and other relevant criteria to reach our conclusions as they pertain to our audit objectives.

Based on the understanding of DBEDT's film tax credit administration gained through our review of relevant documents and interviews, we judgmentally selected a sample of 25 productions that the film office certified for the tax credit during 2014 and 2015 that we determined to be representative of the entire population of productions certified for that period. We then reviewed the productions selected to determine whether the film office complied with its own policies and procedures to prequalify and certify taxpayers for the incentive in accordance with the requirements set forth in section 235-17, HRS, and DoTAX's proposed administrative rules.

Objectives of the Audit

1. Assess the adequacy of DBEDT management's planning and implementation of the film tax credit, in conjunction with DoTAX.

2. Assess the adequacy of DBEDT's administration of the film tax credit.

3. Make recommendations as appropriate.

Auditor's access to information

Throughout our audit, we requested information and various documents from the film office. However, we experienced significant delays in obtaining some of the documents requested. For example, we requested actual production expenditure information for 2013 and 2014 from

the film office on December 22, 2015. The office did not make the information available to us until April 7, 2016.

We were granted access to nearly all production file contents during the fieldwork phase of the audit, with the exception of the certification letters issued by the film office to productions, which productions must submit to DoTAX to claim the tax credit. We could not gain unredacted access to the letters because they are considered confidential tax documents that are part of the taxpayers’ returns. Because our access to these certification letters was restricted, we could not independently verify the certified expenditure and credit amounts that were provided by the film office.

Chapter 2

DoTAX's Inadequate Regulation Has Increased Costs and Hindered Assessment of Film Tax Credits

HAWAI'I HAS A LONG HISTORY as a location for movies and television shows, including recent, big-budget blockbusters such as *Jurassic World* and *Godzilla*, and TV series such as *Hawai'i Five-0*. Since 1997, productions have received taxpayer aid in the form of generous film tax credits. In return, the productions have created jobs, infused millions of dollars into Hawai'i's economy, and provided global exposure that supports the State's visitor industry. However, we found that inadequate administration of the film tax credit by DoTAX and the film office has likely increased the cost of the credit, while inflating the possible economic benefits that it provides to the State. The film tax credits are set to sunset at the end of December 2018, at which time the Legislature will need to decide whether the benefits of the incentive justify its continuing costs. Unfortunately, the film office cannot provide the Legislature with the relevant, accurate, and timely data necessary to make this determination. We also identified internal control deficiencies that are noted in Chapter 3 of this report.

Summary of Findings

1. DoTAX has broadened the scope of the film tax credit by including out-of-state expenses as "qualified production costs." This action, which is inconsistent with the plain language of the statute and the legislative intent of the incentive, increases the cost of the film tax credit to the State.

2. DoTAX has not adopted administrative rules needed to provide assurance that the film tax credit is properly administered. Without such rules, tax credit qualification requirements are unclear, the film office does not have the administrative tools to enforce deadlines and other filing requirements, and there is little assurance that claimed production costs qualify for the tax credit.

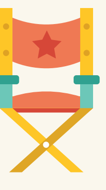
3. The lack of reliable and timely information makes it difficult to evaluate whether, from a cost-benefit perspective, the film tax credit is beneficial to the State and for the Legislature to determine whether or not to extend the credit beyond 2018.

Allowing out-of-state expenditures to qualify for the film tax credit increases the credit's cost to the State.

As it is currently administered, Hawai'i's film tax credit subsidizes not only a production's in-state expenditures, but also spending for some goods and services in other states. How much this out-of-state spending inflates costs to the State is unclear; what is apparent, however, is that the policy is not consistent with the film tax credit statute.

20/25

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



The film tax credit, codified in section 235-17, HRS, provides a refundable tax credit in the amount of 20 percent of qualified production costs incurred on O'ahu or 25 percent of qualified production costs incurred on a neighbor island. "Qualified production costs," or the costs that are eligible for the credit, are defined by statute as "the costs incurred by a qualified production *within the State* that are subject to the *general excise tax under chapter 237* or *income tax under [chapter 235]*."[1] However, we found that DoTAX has expanded the film tax credit to include production expenditures incurred *outside of the State* that are subject to Hawai'i's *use tax* under chapter 238, HRS.[2] The use tax is a means for the State to tax goods and services acquired *outside of the State* that are not subject to the general excise tax (GET).[3] DoTAX justifies its position by noting that the use tax effectively serves as "a substitute" or "tax equivalent" for Hawai'i's GET and that it was established to ensure "a level playing field" for business transacted inside and outside of Hawai'i.[4]

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[1] Section 235-17(l), HRS (emphasis added).

[2] In 2009, DoTAX issued Tax Information Release (TIR) No. 2009-05, which included DoTAX's proposed administrative rules relating to the film tax credit. In relevant part, section 18-235-17-16 of the proposed rules provides:

> Because chapter 238, HRS, is a substitute for Hawai'i general excise tax, production costs incurred by a qualified production in Hawai'i, which would otherwise qualify as a qualified production cost, are considered subject to tax within the meaning of section 235-17(l), HRS, where the production cost (as either an item of tangible personal property, service, or contracting) is imported into Hawai'i and is subject to the use tax under chapter 238, HRS, and the use tax is actually paid.

TIR No. 2009-05 at 32 (proposed rule section 18-235-17-16(c), Hawai'i Administrative Rules (HAR). The TIR specifically states that the proposed rules, including the above quoted section, "serve as [DoTAX's] positions" and that "Taxpayers may rely upon this TIR and the accompanying revised proposed administrative rules[.]"

[3] The GET is a tax assessed on a wide range of businesses and other activities in the state based on values of products, gross sales, or gross income. Section 237-13, HRS.

[4] TIR No. 2009-05 at 32 (proposed rule section 18-235-17-16(a)-(b), HAR).

When implementing a legislatively enacted policy, such as the film tax credit, an agency's foremost obligation is to ascertain and put into effect the intention of the Legislature, which is obtained primarily from the language of the statute.[5] Where the statutory provision is unambiguous, the agency's duty is to put into effect the statute's plain and obvious meaning.[6]

The definition of qualified production costs in the film tax credit law appears to be unambiguous: "costs incurred by a qualified production *within the State* that are subject to the *general excise tax under chapter 237* or *income tax under this chapter*."[7] Costs subject to the use tax, by definition, are not incurred "*within the State*"; those costs are not subject to tax under either chapter 237 or chapter 235.

SUBSIDIZING OUT-OF-STATE BUSINESSES

Hawai'i's use tax law, chapter 238, HRS, imposes a levy on out-of-state goods and services imported for use in Hawai'i. Providing production companies with tax credits for such expenditures eliminates the intended incentive to hire Hawai'i vendors and purchase goods in the State.

By extending the film tax credit to include production costs that are incurred *outside of the State*, DoTAX appears to have exceeded its authority. DoTAX's understanding that the use tax is intended to "complement" the GET in the State's overall excise tax regime does not allow DoTAX to unilaterally expand the breadth of the film tax credit to include costs beyond those identified and included by the Legislature.

If a statute is ambiguous, an agency may consider the reason and spirit of the law in interpreting the law.[8] However, we found that DoTAX's interpretation of the film tax credit statute to include out-of-state expenditures subject to the use tax is contrary to the law's overarching purpose. The legislative history of the statute reflects that, in 2006, the Legislature expanded the film tax credit to promote film industry growth in Hawai'i because the industry "[i]nfuses significant amounts of new money into the economy" and creates skilled, high-paying jobs and income for Hawai'i residents. Although the Legislature cited other purposes—to support Hawai'i's tourism industry and enable Hawai'i to compete with other states, for instance—the broad purpose was to stimulate economic growth in Hawai'i. Construing qualified production costs to include expenditures subject to the use tax means the State is subsidizing some of a production's out-of-state costs. Expenditures paid to out-of-state businesses and service providers do not infuse money into the Hawai'i economy or provide income for local residents; they do not create local jobs. Instead, those out-of-state expenditures infuse money and jobs into economies of other states, which appears to be neither the intent nor the spirit of Hawai'i's film tax credit.

Our belief that DoTAX has exceeded its authority notwithstanding, we found that DoTAX does not follow its own written policy before

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[5] See State v. Toyomura, 80 Haw. 8, 18, 904 P. 2d 893, 903 (1995); Jou v. Hamada, 201 P. 3d 614, 620-21 (Haw. App. 2009).

[6] Toyomura, 80 Haw. at 18, 904 P. 2d at 903; see also sections 1-14 and -15, HRS.

[7] Section 235-17 (1) (emphasis added).

[8] Section 1-15, HRS.

qualifying out-of-state expenditures for the tax credit. DoTAX requires that the use tax be paid before the cost qualifies for the credit.[9] However, we found that the requirement is not enforced. DoTAX does not confirm with the production or through other means that the use tax had been paid. DoTAX believed that the film office was requiring some proof that the use tax had been paid before verifying that the expenditure was a qualified production cost eligible for the tax credit; however, the film office does not require any such proof or even require a production to represent that the use tax had been paid. Moreover, neither DoTAX nor the film office are aware of the amount of out-of-state expenditures for which productions have received tax credits. Without such information, we could not determine the amount of additional cost to the State caused by DoTAX's expansion of the film tax credit.

We note that a number of other states subsidize out-of-state spending by productions through their respective film tax credits. For instance, while Georgia, Louisiana, Minnesota, North Carolina, Tennessee, and Washington subsidize purchases only from in-state vendors, Massachusetts and New York allow out-of-state costs as qualifying expenditures. However, as discussed above, based on both the plain language of the statute and the legislative history, we understand Hawai‘i's film tax credit to apply to certain production expenditures *incurred in Hawai‘i* , not out of state. If either DoTAX or the film office believes that the film tax credit should include out-of-state expenditures, we recommend that they request the Legislature to amend the statute to reflect that intent. Unless and until that happens, we strongly recommend that DoTAX and the film office allow productions to claim the film tax credit only for those production expenditures that are subject to Hawai‘i GET or income tax, as the law currently states.

DoTAX appears to include other types of expenditures as qualified production costs that are inconsistent with the plain language of the statute.

In our review of DoTAX's proposed administrative rules, we found that DoTAX appears to allow other costs to qualify for the film tax credit that are outside and beyond those expenditures that the statute defines to be qualified production costs.

The proposed rules include as qualified production costs: (1) the cost of insurance premiums that are subject to Hawai‘i's insurance premium tax under chapter 431, article 7;[10] and (2) the amount of the depreciation

[9] TIR No. 2009-05 at 32 (proposed rule section 18-235-17-16(c), HAR).

[10] TIR No. 2009-05 (proposed rule section 18-235-17-14, HAR).

allowance for fixed equipment owned by a production company that is used in multiple productions.[11] However, as discussed above, the statute includes only those production costs that are "subject to the general excise tax under chapter 237 or income tax under [chapter 235]." Neither the cost of insurance[12] nor the depreciation allowance are subject to the GET or income tax.

The total amount of the insurance premiums and depreciation allowances qualified for the film tax credit are unknown, as neither DoTAX nor the film office track data on these production expenditures. However, we noted that a production with qualified production expenditures of nearly $40.5 million incurred more than $352,000 in insurance costs, which resulted in more than $70,000 in tax credit to the production.

As with the out-of-state expenditures, we strongly recommend that DoTAX and the film office allow productions to claim the film tax credit only for those production costs that are subject to Hawai‘i GET or income tax until the statute is amended to include costs subject to the insurance premiums tax and/or the amount of a production's depreciation allowance for fixed equipment as qualified production costs.

Without administrative rules, the film office cannot ensure that film tax credits are awarded properly.

Administrative rules are essential to an agency's ability to administer a legislatively enacted program. While the Legislature establishes a program's broad framework through statute, rules may be necessary to provide program details, including, for instance, the specific requirements and procedures needed to comply with the statute's conditions. In fact, Hawai‘i law requires an agency to engage in "rulemaking" to adopt any "statement of general or particular applicability and future effect that *implements, interprets, or prescribes law or policy*, *or describes the organization, procedure, or practice requirements.*"[13] Those rules are promulgated pursuant to the Hawai‘i Administrative Procedure Act,

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[11] TIR No. 2009-05 (proposed rule section 18-235-17-15, HAR).

[12] Although the statute includes a non-exclusive list of the types of expenditures that constitute qualified production costs, one of which is "[i]nsurance and bonding," the Legislature appears to have intended that only the costs associated with insurance and bonding that are subject to the GET or income tax be eligible for the film tax credit. In contrast, the Legislature included as qualified production costs the rent or fees for use of State or county facilities, notwithstanding that they are not "subject to the general excise tax under chapter 237 or income tax under [chapter 235]." Section 235-17(l), HRS.

[13] Section 91-1(4), HRS (emphasis added). Regulations concerning only an agency's internal management, which do not affect private rights or procedures available to the public, are not "rules" and, therefore, are not required to be implemented in accordance with chapter 91.

chapter 91, HRS, which requires, among other things, public notice and an opportunity for public comment.[14] Generally, once adopted, the rules have the force and effect of law.[15]

In the context of the film tax credit, the statute contains a number of requirements that a production must satisfy to qualify for the tax credit. Among other things, a production must provide: (1) "a shared-card, end-title screen credit"; (2) evidence of "reasonable efforts to hire local talent and crew"; and (3) evidence of "financial or in-kind contributions or educational or workforce development efforts" that further the local film and television and digital media industries. In addition, productions must "prequalify" by registering with the film office and submitting a post-production report to the film office.

The statute, however, lacks the detail necessary for productions to understand how to specifically satisfy the requirements to qualify for the tax credit and for the film office to properly administer the incentive. For instance, while it is clear that a production must provide "financial or in-kind contributions or educational or workforce development efforts," the statute does not state the amount of monetary or in-kind contribution needed to satisfy that requirement. We believe that administrative rules are necessary to specify how DoTAX interprets and intends to implement the statute, including the required minimum amount of financial or in-kind contributions.

The Legislature specifically empowered the DoTAX director to require productions to furnish information that the director deemed necessary to determine the validity of a production's claim for the tax credit and to implement rules to effectuate the purposes of the statute.[16]

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

In 2009, DoTAX issued a Tax Information Release (TIR), which, as discussed above, included *proposed* rules to implement the film tax credit.[17] DoTAX originally said it intends to adopt the rules before the

[14] Section 91-3, HRS.

[15] State v. Kimball, 54 Haw. 83, 89, 503 P. 2d 176, 180 (1972).

[16] Section 235-17(g), HRS.

[17] The DoTAX rules officer said those proposed rules have subsequently been revised, but because they had not yet been finalized, DoTAX provided the most recent version of the draft proposed rules to us, with the understanding and agreement that the document was a confidential draft. For that reason, we refer herein only to the version of the proposed rules that were included in the 2009 TIR, which we understand to be DoTAX's most recent pronouncement regarding its position with respect to the film tax credit. We do not believe that the new proposed rules change the analysis contained herein.

end of 2016. However, as of the date of this report, DoTAX's temporary rules still have not been approved by the governor for public hearing. DoTAX stated that, if the governor approves them before the end of 2016, the rules will be issued as a public draft. The rules officer, who assumed his current position in 2013, said that he did not know why it had taken the department *more than seven years* to begin the process to formally adopt the rules.

The TIR states that the proposed rules "serve as [DoTAX's] position" and "[t]axpayers may rely upon [the] TIR and the accompanying revised proposed administrative rules[.]" However, the proposed rules are not official and, therefore, have no legal effect until approved by the governor.[18] Consequently, while taxpayers may rely upon the proposed rules, neither DoTAX nor the film office can require compliance with the procedures and other eligibility requirements stated therein. Rather, those rules merely provide guidance to productions, and DoTAX and the film office can only rely upon productions' voluntary compliance.

Administration of the film tax credit has been superficial.

We found ample evidence that, without the ability to compel and enforce compliance with the proposed rules, DoTAX and the film office's administration of the film tax credit has been superficial. Neither DoTAX nor the film office can compel a production to provide certain information or to take specific action to satisfy the statutory requirements, and it is unclear as to the consequence, if any, of a production's failure to register with and submit documents to the film office within the timeframe required by the statute. For instance, we found seven registration forms that were approved by the film office even though they were received after the deadline required in the proposed rules.[19] In one instance, the registration form was received more than one year after the first Hawai‘i shoot date. We also found two production reports that were received by the film office after the 90-day deadline.[20] Although the deadline is set by statute, the DoTAX rules officer said that the law does not specify any penalty for missing the deadline. Without rules to provide further guidance, the film office currently consults with DoTAX on a case-by-case basis to decide whether a production has waived its ability to claim a film tax credit because it missed a deadline.

It has been more than ten years since the current form of the film tax credit was enacted, and as noted herein, the lack of rules has resulted in minimal accountability and has severely restricted the film office's ability to properly administer the credit.

[18] Section 91-3(c), HRS.

[19] The proposed rules require a production to submit its prequalification registration to the film office no later than one week *before* principal photography begins. TIR No. 2009-05 at 15 (proposed rule section 18-235-17-02(a), HAR).

[20] No later than 90 days after the end of the tax year in which the qualified production costs were incurred, a production must submit a sworn statement to the film office, which includes a detailed expenditure report. Section 235-17(h), HRS.

We have serious concerns about DoTAX's extended delay in promulgating rules. It has been more than *ten years* since the current form of the film tax credit was enacted, and as noted herein, the lack of rules has resulted in minimal accountability and has severely restricted the film office's ability to properly administer the credit. While we strongly recommend that DoTAX promulgate rules without any further delay, we found a number of provisions in the most recent public version of the proposed rules that should be revised to provide greater assurance that the film tax credits are being managed in accordance and consistent with the statute's intent and that the State is receiving reasonable benefit relative to the amount of the tax credit that a production receives. Those provisions are discussed below.

Productions should be required to obtain independent, third-party reviews to certify that production costs are eligible for the film tax credit.

States are increasingly requiring independent verification of production expenditures under their film tax incentive programs. At least 15 states now require an audit or other third-party review of a production's expenditures.[21] Colorado, for example, requires a production's requested credit, including the total amount of qualified local expenditures, financial information, production workforce information, and all back-up documentation, to be independently verified by a certified public accountant (CPA). Maryland and Tennessee require an independent, third-party auditor's report on agreed-upon procedures performed by a licensed CPA. Louisiana directly engages a CPA to prepare a production expenditure verification report on an applicant's cost report of production expenditures, and the applicant is assessed Louisiana's actual cost for the production expenditure verification report fee.

DoTAX's proposed rules require productions with qualified production costs of $1 million or more to provide the film office with independent verification of the qualified costs.[22] Although the requirement has not been approved and, therefore, cannot be enforced, a limited number of Hawai'i productions voluntarily submitted third-party verification of their qualified production costs.[23] According to the film office,

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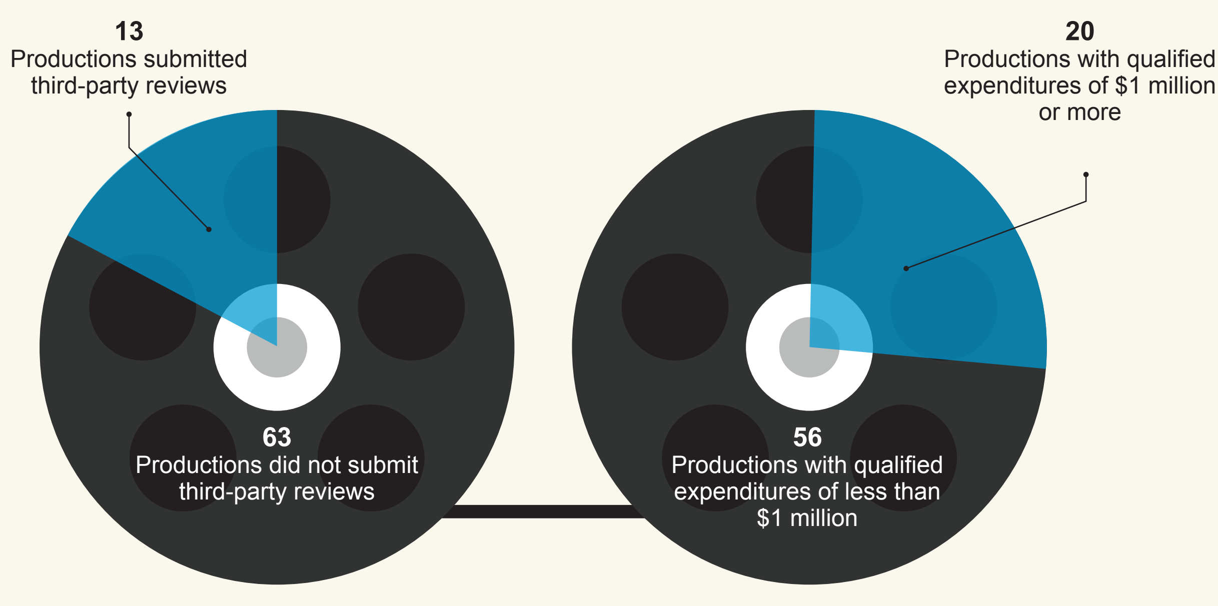
[21] National Conference of State Legislatures, *State Film Production Incentives & Programs*, March 2014.

[22] TIR No. 2009-05 at 35 (proposed rule section 18-235-17-18, HAR).

[23] The film office reported that it requested that a television series with $1.9 million in qualified production costs to submit an independent, third-party verification of those costs. According to the film office, the estimated cost to obtain the requested review was between $10,000 to $12,000, which could be added to the qualified production costs and

fewer than half of the productions submitted third-party reviews with their production reports in 2014, as Exhibit 2.1 shows. Examining those limited instances, we found that independent reviews protect the State's interests by identifying errors that inflate the amount of qualified production costs and, ultimately, a production's tax credit. We found five instances in which the third-party reviews submitted by productions in 2014 and 2015 identified non-qualifying expenditures.

Exhibit 2.1
Number of Hawai'i Productions that Submitted Third-Party Reviews for Calendar Years 2013–2014



Source: Hawai'i Film Office

We agree that an independent, third-party review is essential to proper administration of the incentive. Such a review assures the State that the costs, which are the basis for the amount of a production's film tax credit, are in fact qualified production costs under the statute. A third-party analysis of a production's spending also provides some assurance to the State that those expenditures appear reasonable.

We thus recommend that the State require an independent, third-party verification of production costs for *all* productions applying for the film tax credit, not just productions with $1 million or more in production

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would be eligible for the film tax credit. However, the production said the review was cost-prohibitive to obtain, notwithstanding its request for a $377,000 film tax credit.

costs, as the proposed rules currently provide. Without independent review of a production's expenditures, the responsibility for ensuring that the production meets the certification requirements for the film tax credit falls entirely upon the film office. However, we found that the film office does not adhere to its own policies and procedures for conducting such reviews, which were sparsely documented, and thus provided limited assurance that production expenditures were consistently and thoroughly reviewed. Given that the film office both administers the film tax credit and advocates for the industry, duties which may inherently conflict, independent analyses of production spending can provide greater assurance that the State is allowing the tax credit only for production costs that qualify under the statute.

We suggest that the reviews be performed by third-party accounting firms, verifying that the production costs are eligible under the statute and reporting their findings in an agreed-upon procedures report for each qualified production. However, we suggest that the tax opinion, as described in the proposed rules, provides insufficient verification of the production costs and, therefore, does not provide the requisite assurance of the validity of the amounts claimed for the film tax credit. If the requirement of an independent review cannot be mandated through an administrative rule, we recommend that DoTAX request that the Legislature amend the film tax credit law to require such review.

The rules should specifically describe the efforts to hire local talent and crew that a production must undertake.

To satisfy a statutory requirement that a production make reasonable efforts to hire local talent and crew, the rules should require the production to submit documentary evidence that it contacted Hawai‘i chapters of film industry unions or guilds or that it provided public notice of its desire to hire locally. While the proposed rules list examples of the types of documentary evidence that can be submitted—copies of press releases, flyers, and newspaper ads, for example—we found that the rules provide insufficient detail on how to satisfy the requirement. Without specifics on what constitutes "reasonable efforts," there is minimal assurance that a production's actions are sufficient to justify the amount of the production's film tax credit.

To ensure that the intent and spirit of the film tax credit law are met and to protect the State's interest, we recommend that the rules more clearly define what constitutes "reasonable efforts." This could include, for example, requiring evidence that a production solicited Hawai‘i residents through an advertisement in a local newspaper or other print

publications, and by specifying the size and location of the advertisement and the number of times and frequency that the advertisement must be published. Without such specificity, neither the film office nor productions have sufficient guidance as to what constitutes reasonable local hiring efforts.

Financial or in-kind contributions and education or workforce development requirements should be increased to more appropriately align with the amount of a production's qualified production costs.

The Legislature intended that the film tax credit support and help grow the State's film industry, including developing a local workforce, by requiring productions to make financial contributions to Hawai'i schools or to provide training and educational initiatives and opportunities. Accordingly, the statute requires productions to submit evidence to the film office of "financial or in-kind contributions or educational or workforce development efforts, in partnership with related local industry labor organizations, educational institutions, or both, toward the furtherance of the local film and television and digital media industries."[24] The proposed rules clarify that only one contribution is necessary to fulfill the statutory requirement. The proposed rules further define the monetary amount of the financial or in-kind contributions required under the film tax credit law: "at a minimum, equal to *the lesser of* 0.1 percent of a production's qualified production costs or $1,000."[25] The proposed rules also state that a production may fulfill its workforce development requirement by merely providing "[a]t least *one* on-set or post-production internship" through a local public or charter school[26] or "[a]t least *one* on-set craft apprenticeship" through one of the local labor unions.[27]

We suggest that, when compared to the amount of the film tax credit awarded, the State is not receiving sufficient benefit; that is, the financial contribution and workforce development requirements seem unlikely to help meaningfully grow the local film industry. For example, a production with $1 million in qualified production costs incurred on a neighbor island is entitled to receive a film tax credit of $250,000. Yet, that production can satisfy the requirement by making a monetary contribution of only $1,000, which is only 0.4 percent of its tax credit.

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[24] Section 235-17(d)(5), HRS.

[25] TIR No. 2009-05 at 40 (proposed rule sections 18-235-17-20(d)(1) and -20(d)(2), HAR) (emphasis added).

[26] TIR No. 2009-05 at 40 (proposed rule section 18-235-17-20(d)(3), HAR) (emphasis added).

[27] TIR No. 2009-05 at 40 (proposed rule section 18-235-17-20(d)(4), HAR) (emphasis added).

A production that receives $15 million in film tax credits, which is the maximum statutory amount, can similarly satisfy the requirement by making a $1,000 contribution to a Hawai'i public school; a production with $200,000 in neighbor island incurred qualified production costs may be eligible for a film tax credit of $50,000, but, under the proposed rule, is required to make a contribution of only $200.

While we offer no opinion as to the amount that may be more reasonable for a production to contribute to be entitled to the film tax credit, we recommend that the amount be increased. If a production's financial or in-kind contribution is intended to be more than merely symbolic, we believe that the value must be better aligned with the amount of the tax credit that the production is entitled to receive. Similarly, if one of the purposes of the film tax credit is to develop the local film industry, including training Hawai'i residents, we suggest that requiring only *one* internship or *one* apprenticeship does not meaningfully advance the Legislature's intent of developing Hawai'i's film industry or provide the State with reasonable value relative to the amount of the film tax credit.

Unenforceable and unmonitored requirement for productions to provide end credits to the State raises questions as to whether Hawai'i is receiving exposure benefits.

The Legislature intended that in exchange for subsidizing a certain amount of production costs, productions must provide the State with shared-card, end-title screen credits.[28] However, we found that the film office neither requires a production to submit evidence that it has provided the required screen credit nor independently tracks whether a production complied with the requirement. We found 11 out of 19 productions that we reviewed did not submit screen credits as required by law, despite being certified for the film tax credit.

We also found that the proposed rules are silent as to the screen credit requirement. We recommend that the rules specify how a production must satisfy the screen credit requirement and the evidence or other type of assurance that the production must submit to be eligible for the tax credit and ensure that the production will provide the State with the required screen credit. For example, New York's post-production tax credit application requires submission of a frame grab from the production's end credit sequence to verify that the state was provided credit.[29]

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[28] Section 235-17(d)(3), HRS.

[29] New York State Post-Production Tax Credit End Credit Requirements. http://esd.ny.gov/businessprograms/Data/Film/2016/EndCreditRequirements_Post_2016.pdf

The “benefit” of the film tax credit cannot be reasonably assessed a decade after the incentive was expanded because of insufficient, inaccurate, and untimely production data.

In addition to administering the film tax credits, the film office also is required to report annually on the levels of incentives granted to productions and perform a cost-benefit analysis of the credits. We found that the film office’s analysis of film tax credit data does not measure the incentive’s true costs and reports economic impacts that are based on incomplete and inflated data.

Inclusion of “above-the-line” salary numbers and weak tracking and reporting impair the current economic analysis of the film tax credit.

Prior to each legislative session, DBEDT is required to report the non-aggregated qualified production costs that are the basis for productions’ film tax credit claims to the Legislature.[30] DBEDT is also required to submit a “cost-benefit analysis” of the film tax credit.[31] We found that the film office’s annual report to the Legislature includes an accounting of the office’s costs to administer the credit, which is specifically required by the statute, as well as estimated qualified production expenditures, estimated film tax credits itemized by production, and number of each production’s local and out-of-state hires. The report also includes certain economic impacts that are generated by DBEDT’s Research and Economic Analysis Division (READ) and based on the amount of total qualified production expenditures compiled by the film office. However, the chief state economist, who is the head of READ, acknowledged that these metrics do not constitute a cost-benefit analysis of the film tax credit.[32]

The chief state economist said that a true cost-benefit analysis of the tax credit should take into account the costs, including the amount paid in

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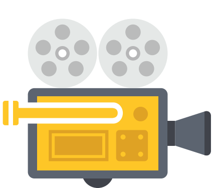
[30] Section 235-17(i)(4), HRS.

[31] Act 89, SLH 2013, section 4. Section 235-17(i), HRS, further requires DBEDT to annually submit a report detailing “the non-aggregated qualified production costs that form the basis of the tax credit claims and expenditures, itemized by taxpayer, in a redacted format[.]”

[32] READ, in collaboration with the Creative Industries Division and the film office, separately produced a creative industries benchmark report in 2007, which it updated in 2010, 2012, 2014, and 2015. The 2015 report includes a number of refined metrics intended to more effectively monitor the progress of Hawai‘i’s creative sector, including the film industry. That report, too, does not analyze the cost-benefit of the film tax credit.

tax incentives, and the benefits to the State. He added that the analysis should include, for instance, the estimated amount of industry earnings by non-residents that "leaked out" of the State, as well as the number of visitors who came to Hawai'i directly because of their exposure to productions filmed in the State. He also noted that the economic impact numbers compiled by READ do not consider the cost to residents and businesses from the closure of public spaces, such as roads and buildings, to accommodate a production's filming. Additionally, READ does not adjust its calculations to account for "free-riders," or those productions that would have filmed in Hawai'i regardless of whether the State offered a film tax credit. Although the chief state economist said factoring in all of this information would be difficult, a true cost-benefit analysis should attempt to quantify these factors to determine whether the film tax credit is a net benefit for Hawai'i.



We found that, for a major motion picture shot in 2014, above-the-line talent earned $3.36 million in wages while filming in Hawai'i. All of these jobs were filled by non-Hawai'i residents.

The film office's report includes READ's calculation of the film tax credit's economic impact to the State. However, we found that analysis to be superficial and overstated, as it includes an unknown amount of out-of-state expenditures and wages paid to non-residents, as well as inaccurate production expenditure data.

READ applies various multipliers to the total amount of qualified production costs provided by the film office in order to estimate how production spending circulates through the economy in the form of household income, other industry sales, and state tax revenue.[33] While we did not examine READ's multipliers, we found that the qualified production costs used to estimate the economic impact of the film tax credit include out-of-state expenditures that have little impact on Hawai'i's economy. Payments to "above-the-line" talent, such as highly paid actors, directors, and producers who often live outside of Hawai'i, are also used to calculate Hawai'i impacts. Although the film office requests productions to report the number of their local and out-of-state hires, it does not track whether actual production jobs are filled by Hawai'i residents or non-residents.

We found instances in which nearly all above-the-line talent salaries were paid to non-Hawai'i residents, and those amounts were included to estimate the film tax credit's local economic impacts. For example, we found that, for a major motion picture shot in 2014, above-the-line talent earned $3.36 million in wages while filming in Hawai'i. All of these jobs were filled by non-Hawai'i residents. The inclusion of these relatively few, high-paying jobs inflates the film tax credit's economic impacts to

[33] For its estimate of the amount of other industry sales generated to support the local economy, READ uses a multiplier of 1.75, which means an additional $0.75 is generated in other industry sales for every $1 that a production spends in Hawai'i. READ's multiplier is 0.42 and 0.12 for household income and tax revenue, respectively.

the extent that these moneys are spent outside of Hawai‘i or paid to non-Hawai‘i residents.

While the non-resident actors, producers, directors, and crew may spend some of their salaries or wages in Hawai‘i, the chief state economist agreed that it is very unlikely that a significant percentage of their Hawai‘i-earned income flows into the local economy; rather, non-resident actors and others spend the bulk of their earnings outside of Hawai‘i, most likely in the states in which they live. However, the chief state economist said that he was unaware that the qualified production costs provided by the film office included out-of-state expenditures and non-resident salaries. Because READ's analysis is a product of two factors–the multiplier and the qualified production costs–the chief state economist said that including the out-of-state costs and expenditures to non-residents distorts the economic impact of the film tax credit.

In reviewing its film tax incentive, Massachusetts recognized the importance of properly tracking data on the types of production hires, as well as out-of-state expenditure amounts, to measure its film tax credit's economic benefits. In its 2016 report, the Massachusetts Department of Revenue found that not all production spending benefits the Massachusetts economy or its residents, noting that production spending "leaks out" of the Commonwealth's economy if spent on imports of goods or services, or employment of non-residents. Payments to Massachusetts residents have much higher multiplier effects than payments to non-residents, since a greater proportion of income earned by residents is spent on local businesses, which, in turn, generates additional local economic activity.

While expenditures to non-resident actors and crew may constitute qualified production costs that are eligible for Hawai‘i's film tax credit, we believe that the film office's inclusion of those expenditures in the base production costs to which READ applies its multipliers greatly over-inflates the economic impact to the State. Productions should be required to report out-of-state expenditures[34] and salaries and wages paid to non-residents, including below-the-line actors and production crew, as part of the post-production reports they submit to the film office. READ should not include these costs to calculate Hawai‘i impacts. To ensure that the film office can require productions to report such information, we recommend that DoTAX require this reporting in the administrative rules that it promulgates to implement the film tax credit, if necessary. We further recommend that the film office consult with READ to determine whether other qualified production costs should be excluded from the

STAR SALARIES SKEW IMPACTS

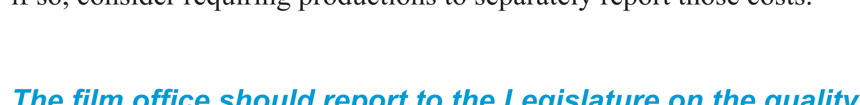
BIG-NAME Hollywood talent often command big salaries; the question for policymakers is: **How much impact do these salaries have on local economies?**

In the case of Walt Disney's *Pirates of the Caribbean: On Stranger Tides*, which was partially shot in Hawai'i in 2010, Johnny Depp reportedly received an upfront payment of **$55 million**, or 22 percent of the production budget. If, hypothetically, Depp earned one-quarter of his wages or **$13.75 million** for filming in Hawai'i, his pay, by itself, would have purportedly generated **$24.06 million** in local sales and more than **$10.11 million** in income for local households, using READ's multipliers.

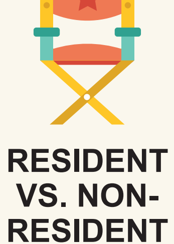
Photo: Peter Mountain © Disney Enterprises, Inc. All Rights Reserved.

[34] As discussed above, in our view, out-of-state expenditures subject to Hawai‘i's use tax are not qualified production costs, as defined in the film tax credit statute, section 235-17(l), HRS. For that reason, even if the statute is amended to qualify the out-of-state expenditures, those costs should not be included in the qualified production costs provided to READ.

economic impact calculation for the incentive's cost-benefit analysis and, if so, consider requiring productions to separately report those costs.



The film office should report to the Legislature on the quality of jobs generated by productions, not simply the number of new jobs.



RESIDENT VS. NON-RESIDENT

In 2013, Massachusetts found that about **68 percent** of the $170.5 million, or almost $116 million, **in film production wages** went to non-residents. Of that amount, about $62 million went to individuals who were paid more than $1 million, all of whom were non-Massachusetts residents.

One key component needed to evaluate the benefits of the film tax credit is information on the quality of the jobs generated by the incentive and whether those positions are filled by residents. For example, reporting that a production hired 100 Hawai'i residents for its film may suggest that the production created many new jobs and infused money into the State's economy. However, if the majority of those Hawai'i residents were hired to be production extras, the economic impact to the State, including job creation, may be relatively insignificant.

Although the film office collects information about the quality of the jobs created by the productions applying for the film tax credit, the film office does not track or report that information.[35] On its production report, the film office requests that productions indicate the number of Hawai'i resident and non-Hawai'i resident hires by category, such as above-the-line directors, producers, writers, and principal cast; talent, including supporting cast and extras; department heads and keys; below-the-line crew; and other hires. Productions are also asked to report the number of local and out-of-state hires by department, from accounting to hair and make-up to visual effects, as well as the number of Hawai'i hires by county residency. Such information, if properly tracked by the film office, could significantly enhance its assessment of the film tax credit's benefits to the State in creating jobs, as intended by the Legislature.

A number of other states that provide production incentives have measured the average salaries of incentivized jobs as one metric for job quality.[36] We agree such information can help the Legislature evaluate the tax incentive. Accordingly, we recommend that DoTAX adopt administrative rules that require productions to include the types of information that the film office's production report currently asks productions to voluntarily report. The data will enable the film office to provide a more comprehensive picture of the incentive's effectiveness in creating skilled, high-paying jobs for Hawai'i residents.

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[35] We note that READ, in the 2015 *Hawai'i's Creative Industries* report, found the number of residents employed by Hawai'i's film and creative media industries declined by an average of 2 percent annually from 2004 to 2014.

[36] The Pew Charitable Trusts 2014, *How to Measure the Results of Tax Incentives: Promising Practices and a Proposal for Nebraska, 2014*. The report additionally notes

Conclusion

In its report to the Legislature for 2015, the film office states that "[t]he Motion Picture, Digital Media and Film production tax credit is performing as the Legislature intended: Stimulating the economy and creating high-paying jobs to serve a clean industry that preserves Hawai'i's natural and cultural resources and provides valuable exposure for our Islands as a world-class filming and visitor destination." However, based on our examination of the film tax credit, we cannot confirm that the film tax credit is resulting in a net benefit for the State because the information reported by the film office is incomplete, inflated, and insufficient.

What we do know is that DoTAX and the film office need to be more accountable for the administration and oversight of the film tax credit. Chief among these changes is the need for DoTAX and the film office to limit the application of the tax incentive to those production costs that the Legislature intended to be eligible for the film tax credit. Out-of-state expenditures subject to Hawai'i's use tax are not qualified production costs, as that term is defined in the film tax credit statute. DoTAX also must adopt administrative rules to fully implement the film tax credit law. Without the necessary definition to statutory requirements, the film office has limited guidance as to its responsibilities in administering the credit and productions may be unclear as to their obligations to qualify for the film tax credit. DoTAX's adoption of administrative rules will give the film office the needed tools to effectively administer the film tax credit and ensure the tax incentive achieves its intended purposes.

Recommendations

1. The Department of Taxation should:

    a. Adopt administrative rules for section 235-17, HRS, and consider incorporating the following provisions:

        i. Require all productions to obtain an independent review by a certified public accountant of qualified production costs and provide the report to the film office prior to being certified for the tax credit;

        ii. Specify actions that satisfy the statutory requirement for productions to make reasonable efforts to hire local talent and crew;

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that there are other factors that may play into the quality of the jobs created by incentives, including the benefits of the jobs, whether they are ongoing as opposed to temporary, and whether they are filled by state residents.

iii. Require a more reasonable minimum financial or in-kind contribution and educational or workforce development contribution of productions and consider basing the amount of such contributions on the amount of a production's qualified production costs;

iv. Require productions to provide proof of the shared-card, end-title screen credit to the film office prior to being certified for the tax credit;

v. Require all productions to provide the following information as part of submitted post-production reports: (1) the number of Hawai'i resident and non-resident hires by category, such as above-the-line, below-the-line, and extras; (2) salary and wage information for resident actors, producers, directors, and other hires; (3) salary and wage information for non-resident actors, producers, directors, and other hires; and (4) any other information that DBEDT determines necessary to estimate the benefits of the tax credit; and

vi. Include a penalty for productions claiming the tax credit that do not meet the 90-day filing deadline to submit their written, sworn statements to DBEDT, similar to the stipulation for productions failing to prequalify for the credit by registering with DBEDT currently in section 235-17(f), HRS.

b. Request the Legislature to amend the statute to address the above recommendations if the department cannot implement the recommendations through administrative rule.

2. The Hawai'i Film Office should:

a. Collaborate with READ to identify the specific production information READ needs to prepare a comprehensive cost-benefit analysis and/or economic output estimates that account for the different categories of jobs created, salaries and wages of resident and non-resident production hires, and any other relevant information; and

b. Improve its reporting to the Legislature on the film tax credit by ensuring that the reported data is accurate, consistent, and timely.

Chapter 3
Internal Controls

INTERNAL CONTROL is a process adopted by those charged with governance and management to provide reasonable assurance that an organization's mission, goals, and objectives will be achieved. Internal controls comprise the plans, policies, procedures, and systems for planning, organizing, and directing operations and measuring, reporting, and monitoring performance. They generally relate to:

- Effectiveness and efficiency of operations;
- Reliability of reporting for internal and external use; and
- Compliance with applicable laws and regulations.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, the reasonable opportunity to prevent, detect, or correct (1) impairments to effectiveness or efficiency of operations, (2) misstatements in financial or performance information, or (3) violations of laws and regulations on a timely basis.

Internal Control Deficiencies— Hawai‘i Film Office

Based on our audit, we found the following internal control deficiencies which we believe are significant to our audit objectives:

Reviews of production company submissions to prequalify and certify for the tax credit are inconsistent.

The film office has implemented policies and procedures for reviewing documents received from production companies to ensure all required forms and information have been submitted at each respective stage. Those policies and procedures include the following checklists to facilitate their reviews: (1) a tax credit task list for reviewing production registration forms to prequalify for the tax credit; (2) a Hawai‘i

production report review checklist for reviewing production reports submitted upon project completion; and (3) a certificate letter checklist for preparing final certification letters. The film office has one staff, an economic development specialist, assigned to perform reviews for all submitted productions.

Of the 25 production files we reviewed, 6 were missing tax credit task lists, 1 production report review checklist was only partially completed, and 4 certificate letter checklists were blank. Because these reviews are not consistently documented, they provide limited assurance that all required documents and information are received from production companies before they are prequalified or certified for the tax credit. Additionally, although the tax credit task list and production report review checklist include steps to ensure the registration form and production report are "filled out completely," we found one registration form and three production reports submitted by productions that were incomplete.

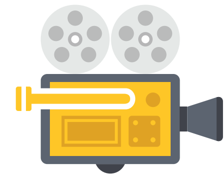
Certifications of qualified production expenditures are not well-documented.

Productions applying for the film tax credit are required to submit a production report no later than 90 days following the end of each taxable year in which qualified production costs were expended. The production report must include a detailed report of qualified production expenditures. Film office policies and procedures state that personnel are required to review expenditures to ensure they qualify for the tax credit, which may entail reviewing expenditures line-by-line, or spot-checking expenditures of larger productions, such as major motion pictures. The process also involves checking for calculation errors, misstatements, and unusual or excessive expenditures.

We found that the film office does not consistently do line-by-line reviews or spot-checks of production expenditure reports. Eleven of 25 production files we reviewed showed minimal evidence of film office review, some containing only checkmarks next to the total expenditures amounts. We also noted several discrepancies in expenditures that had not been detected, although the affected productions had been certified. The same economic development specialist is also the only staff assigned to conduct these certification reviews, and when asked whether she reviews line-by-line, she stated that she "does her best."

Annual reports to the Legislature are inaccurate and inconsistent.

Section 235-17, HRS, requires DBEDT to submit a report to the Legislature before each regular session detailing the non-aggregated qualified production costs that form the basis of tax credit claims and expenditures, itemized by taxpayer, in a redacted format to preserve taxpayer confidentiality. We found that the reports prepared by the film office are not formally reviewed or verified before submission to the Legislature, resulting in inaccurate reporting of film tax credit information to policymakers.



We found the total qualified expenditures of $163 million in 2014's annual report were overstated by $21 million because of inaccurate allocation of a television series' expenditures that spanned calendar years 2014 and 2015.

For example, we found discrepancies in qualified expenditures and jobs data for 15 of 25 productions reported in calendar years 2014 and 2015 when comparing that data against registration forms. Additionally, reports submitted to the Legislature for 2013 through 2015 state that the total amounts in the report "are *estimates* based on the respective Hawai'i Production Registration applications." However, we found several inconsistencies in which reported data were based on actual figures taken from production reports rather than registration forms. The film office's 2013 and 2014 annual reports further state that DBEDT will provide a subsequent report to the Legislature "that details the actual production expenditures" before the 2015 and 2016 legislative sessions, respectively. The film office has not yet submitted such reports.

In addition, the film office provided us with internal drafts of updated reports for 2013 and 2014,[1] which detailed actual qualified production expenditures. When we compared these updated figures to the annual reports submitted to the Legislature, we found that reported qualified production expenditures were overstated by approximately $29 million and $49 million for 2013 and 2014, respectively. Further, we found discrepancies in 5 of the 17 production files we reviewed for 2014 when comparing the 2014 updated draft report to production report documents.

[1] According to film office personnel, these updated draft reports have not been submitted to the Legislature.

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Office of the Auditor's Comments on the Affected Agencies' Responses

WE TRANSMITTED A DRAFT of this report to the Department of Taxation (DoTAX) and Department of Business, Economic Development, and Tourism (DBEDT) on October 28, 2016, and met with representatives of both departments, jointly, on November 1, 2016, to discuss the draft. DoTAX and DBEDT subsequently provided written responses to the draft report, which are Attachments 1 and 2, respectively. At our request, DoTAX provided a copy of the memorandum from the Hawai‘i Department of the Attorney General (Attorney General) dated October 17, 2016, that is referenced in its response as support for DoTAX's expansion of the film tax credit to include productions' out-of-state expenses. The Attorney General's memorandum is included herein as Attachment 3.

For the reasons explained in detail below, we disagree with the majority of DoTAX's and DBEDT's responses to the draft audit report. Where we agree with points raised in DoTAX's and/or DBEDT's responses, we also indicate our agreement to those positions herein and report any revisions to the draft report that were made to address those points.

DoTAX's Response to the Draft Audit Report

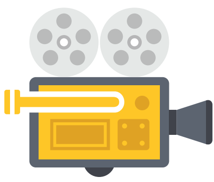
The film tax credit statute defines, unambiguously, the production costs that qualify for the credit to be those costs that a production incurs "*within the State that are subject to the general excise tax under chapter 237 or income tax under [chapter 235]*." We found that DoTAX has expanded the cost of the film tax credit to the State by allowing *out-of-state expenditures* that are subject to the *use tax under chapter 238* to qualify for the tax credit.

DoTAX disagrees with our finding, quoting an Attorney General opinion that DoTAX requested to respond to our finding: "To avoid subjecting the film tax credit to constitutional challenge, the [DoTAX] Director has correctly recommended the inclusion of the use tax as a qualified production cost."

While we have no position about the constitutionality of the film tax credit statute, we disagree that the DoTAX director can ignore the

statute's plain and unambiguous language. As we explained in our report, it is well-settled that "the fundamental starting point for statutory interpretation is the language of the statute itself. . . . *[W]here the statutory language is plain and unambiguous, [an agency's] sole duty is to give effect to its plain and obvious meaning*."[1]

Moreover, the DoTAX director's belief that the film tax credit law, as written, may be unconstitutional[2] does not allow him or her to, in essence, create a new tax credit for productions' out-of-state costs. The separation of powers doctrine, which is one of the tenets of our democratic form of government, confers distinct and separate powers on each branch of government: the legislative branch makes, amends, and modifies laws; the executive branch, of which DoTAX is a part, is responsible to "faithfully execute" those laws; and the judicial branch interprets those laws. By "amending" the film tax credit statute's definition of the types of production costs that qualify for the tax credit, DoTAX has engaged in lawmaking. DoTAX cannot usurp the Legislature's power simply because it has concerns that the statute may be subject to a constitutional challenge.[3] As stated in our report, DoTAX must ask the Legislature to amend the statute to address what it believes may raise constitutional issues.



Moreover, the DoTAX director's belief that the film tax credit law, as written, may be unconstitutional does not allow him or her to, in essence, create a new tax credit for productions' out-of-state costs.

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[1] *Awakuni v. Awana*, 115 Hawai'i 126, 133, 165 P.3d 1027, 1034 (2007). The Attorney General quotes the same language in its memorandum purportedly as support for DoTAX's expansion of the film tax credit law to include the cost of insurance premiums that are subject to tax under chapter 431. *See* Memorandum at 6-7. Similar to DoTAX's inclusion of the out-of-state costs, we found that DoTAX improperly allowed the cost of insurance subject to the insurance premium tax under chapter 431 to be eligible for the film tax credit. We believe that the Attorney General's analysis with respect to that finding is directly contrary to well-settled legal precedent, including the Hawai'i Supreme Court opinion quoted therein, and therefore, is unpersuasive. In opining that "the plain reading" of the film tax credit statute supports DoTAX's inclusion of the cost of insurance subject to the insurance premium tax under chapter 431, the Attorney General myopically focuses on one term in section 235-17(l), HRS, ignoring the unambiguous language immediately above that term: "Qualified production costs" means the costs incurred by a qualified production within the State *that are subject to the general excise tax under chapter 237 or income tax under [chapter 235]*. . . . Qualified production costs include but are not limited to . . . insurance and bonding." (Emphasis added).

[2] It also is beyond the DoTAX Director's authority to declare the statute to be unconstitutional. The Hawai'i Supreme Court has expressly held that "[a]gencies may not … pass upon the constitutionality of statutes." *HOH Corp. v. Motor Vehicle Indus. Licensing Bd., Dep't. of Commerce and Consumer Affairs*, 69 Haw. 135, 141, 736P.2d 1271, 1275 (1987).

[3] When a court determines that a statutory provision is unconstitutional, the state agency that administers that provision is not then allowed to amend the language of the statute to address the constitutional infirmaties; rather, the provision has no effect, i.e., it is void *ab initio*. The Legislature has the power to "fix" the provision by amending the statute or enacting a new law. We are unaware of any legal authority that would change the process and confer the legislative power on the DoTAX Director simply because he or she, rather than a court, declares the film tax credit statute may be unconstitutional.

DoTAX also disagrees with our finding that its delay of more than ten years in adopting administrative rules has deprived both DoTAX and the film office of the tools necessary to properly administer the film tax credit and to ensure that the State's interest is adequately protected. DoTAX's apparent belief that the Tax Information Releases (TIRs) provide sufficient guidance for taxpayers and the film office is misplaced. As we noted in the report, the TIRs are *not* mandatory; i.e., neither DoTAX nor the film office can require compliance with the TIRs. We believe that chapter 91 *requires* DoTAX to enact administrative rules to implement the film tax credit and that the "guidance" that DoTAX has offered through the TIRs does not satisfy that statutory requirement. We strongly recommend that DoTAX consult with the Attorney General as to whether its practice of issuing TIRs in lieu of enacting administrative rules, when necessary, is appropriate.

DoTAX added that the governor approved temporary film tax credit rules that took effect on October 20, 2016, and are effective for 18 months. Because the temporary rules were approved *subsequent to* the completion of our fieldwork, we did not consider the temporary rules for purposes of our report. We have not reviewed the temporary rules and simply accept DoTAX's representation as to the content of those rules. To the extent that the temporary rules do not fully include or address our recommendations contained in the report, we continue to believe that DoTAX should implement those recommendations through rule or, if necessary, request that the Legislature amend the statute.

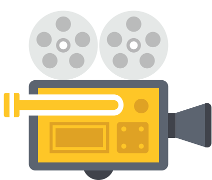
Lastly, DoTAX notes that a graphic in the draft report, Exhibit 1.3, mistakenly reported that 128 productions received a film tax credit for tax year 2011. As DoTAX explained, 128 was the number of tax returns that claimed the film tax credit, not the number of productions. We have amended the information, including the graphic, in the final version of our report.

DBEDT's Response to the Draft Audit Report

DBEDT agreed that improved internal controls and administration of the processing of tax credits are needed to provide the Legislature with more accurate and meaningful information on productions benefitting from the credits. DBEDT also agreed, generally, with our recommendation that productions be required to increase their financial or in-kind contributions, and education or workforce development efforts in order to receive film tax credits. The department said it already has implemented a new procedure for verifying that productions benefitting from the incentives give credit to the State.

The department agreed with our recommendation to require third-party reviews to verify that production costs qualify for tax credits,

but disagreed that all projects should have such reviews. DBEDT argued that such a requirement would discourage $1 million or smaller productions from being made in Hawai‘i. We are unaware of any objective basis to support DBEDT's belief. Moreover, DBEDT fails to understand the basis for our recommendation: there is an inherent conflict between the department's dual roles, which require it to both promote the film industry as well as to "police" the tax incentives provided to productions. We maintain that third-party reviews provide greater assurance for the State that tax credits are provided only for those costs that qualify under statute and, for that reason, believe that our recommendation should be implemented.



The department misunderstands our point that out-of-state expenditures and wages paid to non-resident talent generate less economic impact in Hawai‘i than in-state expenditures and wages paid to Hawai‘i residents.

DBEDT disagreed with our finding that out-of-state expenditures inflate the credit's economic impacts. DBEDT argued that productions usually buy goods and services from out-of-state vendors only when they are unavailable in Hawai‘i. The department misunderstands our point that out-of-state expenditures and wages paid to non-resident talent generate less economic impact in Hawai‘i than in-state expenditures and wages paid to Hawai‘i residents. We believe that those differences should be reflected in reports to the Legislature to provide a more accurate and meaningful picture of the economic impact on other industry sales, household income, and other similar metrics. As we noted in the report, currently, DBEDT includes the out-of-state expenditures as well as wages paid to non-residents, the vast majority of which likely are spent outside of Hawai‘i, in calculating a production's impact on the State's economy.

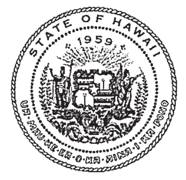
With regards to our finding that the benefits of the tax credits cannot be reasonably assessed, DBEDT stated that its reports to the Legislature on the costs of the credits comply with minimum statutory requirements,as they include the most recent data available when issued. Our audit acknowledges that reports to the Legislature include a "cost-benefit analysis" that meets minimum requirements. However, we found the film office's complacent practices result in incomplete and inflated data that distort the true costs of the credits. DBEDT also misses our broader point that administrative rules are needed to ensure productions provide the State with information on jobs, salaries, and other data needed to better evaluate whether the benefits of the credits offset their costs. As we note in our report, DBEDT failed to update reported production expenditure data as promised in previously submitted reports, which resulted in significant overstatements.

DBEDT raised the same concern as DoTAX about the number of productions that claimed the film tax credit in tax year 2011. As reported above, we have amended the information, including the graphic, in the final version of our report.

We made other changes to correct certain factual errors in the draft report.

DAVID Y. IGE
GOVERNOR

SHAN TSUTSUI
LT. GOVERNOR



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November 4, 2016

The Honorable Leslie H. Kondo
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, HI 96813-2917

Re: Audit of Motion Picture, Digital Media, and Film Production Income Tax Credit

The Department of Taxation ("DOTAX") is responding to the draft report of the Audit of Motion Picture, Digital Media, and Film Production Income Tax Credit ("film credit") dated October 28, 2016.

1. *Chapter 2: (1) Allowing out-of-state expenditures to qualify for the film tax credit increases the credit's cost to the State, and (2) Including other types of expenditures as qualified production costs that are inconsistent with the plain language of the statute.*

DOTAX obtained an opinion from the Office of the Attorney General ("Attorney General") on the interaction of the general excise tax, chapter 237, Hawaii Revised Statutes (HRS) and the use tax, chapter 238, HRS, as regards "qualified productions costs" as defined in section 235-17, HRS. DOTAX also obtained an opinion from the Attorney General regarding whether insurance premiums are qualified production costs within chapter 235-17, HRS.

The Attorney General's opinion dated October 17, 2016 states that the general excise tax and use tax are complementary taxes and concludes that "[t]he inclusion of the use tax as a qualified production cost in spite of its exclusion from the plain language of the statue and the inclusion of insurance premiums in the plain language of the statute appear to be proper. The Director's treatment of both costs are grounded in well-established case law… To avoid subjecting the Film Credit to constitutional challenge, the Director has correctly recommended the inclusion of the use tax as a qualified production cost. The Director appears to be appropriately reading the plain language of the Film Credit in including insurance premiums."

2. *Chapter 2: Without administrative rules, the film office cannot ensure that film tax credits are awarded properly.*

DOTAX disagrees with the Auditor's assessment that neither DOTAX nor the Film Office can require a production to provide information to satisfy the statutory requirements without administrative rules. Section 235-17(g), HRS, provides DOTAX with the authority to

require taxpayers to furnish information to ascertain the validity of the claim for the film credit. Sections 235-17(f) and 235-17(h), HRS, authorize the Film Office to require taxpayers to submit information necessary to ascertain that all requirements have been met before certifying qualified production costs. DOTAX has repeatedly informed the Film Office that it is not required to certify any production costs that it is unable to validate. DOTAX brought to the Film Office's attention Sections 235-17(f) and 235-17(h), HRS, which provides authority to require information from taxpayers before certifying qualified production costs.

The Film Office has always been welcome to ask for DOTAX's guidance on specific questions. The Film Office has never brought to DOTAX's attention that they were not able to administer the credit due to lack of guidance. Since the passage of Act 88, Session Laws of Hawaii (SLH) 2006, DOTAX has issued guidance in the forms of Tax Announcements and Tax Information Releases, which has often been utilized by the Film Office and taxpayers. Although DOTAX guidance did not take the form of administrative rules specifically, DOTAX provided substantial guidance to the Film Office to enable them administer the film credit.

DOTAX Announcement (TA) No. 2006-05, "Act 88, SLH 2006, Relating to Digital Media (Act 88)," was issued on June 13, 2006. TA No. 2006-05 discusses at length the film credit and the requirements to qualify for the film credit. It explains that (1) a taxpayer *must* register with the Department of Business, Economic Development, and Tourism (DBEDT) during the development or pre-production stage for prequalification purposes, and (2) failure to register may result in *losing the right to claim the film tax credit under Act 88*. TA No. 2006-05 requires any taxpayer claiming a film tax credit for a qualified production under Act 88 to submit a written sworn statement to DBEDT no later than 90 days following the end of each taxable year in which qualified production costs were expended. The statement *must* contain all qualified production costs incurred in the previous taxable year; the amount of film tax credits claimed in the previous taxable year; and the comparison of the number of total hires and the number of local hires by category, such as department, and by county.

DOTAX Tax Information Release (TIR) No. 2006-02, "Refundable Income Tax Credit for Persons Engaged in the Motion Picture, Television, and Digital Media Production Business," was issued on July 14, 2006. TIR No. 2006-02 (1) provides guidance and examples regarding qualified productions costs under Act 88, (2) provides guidance and examples regarding prorating qualified production costs between the islands and (3) explains and provides examples regarding the $200,000 minimum expenditure timeline.

TIR No. 2008-02, "Advanced Notice of Proposed Administrative Rules Relating to the Taxation of the Motion Picture and Television Film Production Industry," was issued on August 8, 2008. TIR No. 2008-02 provides notice of proposed film credit rules, includes the full text of the proposed film credit rules, and makes clear the rules represent DOTAX's (and thus the State's) policy regarding the film credit.

DOTAX TA No. 2008-08, "Notice of Informal Comment Period Closing for TIR No. 2008-02," was issued on October 31, 2008. TA No. 2008-08 informs the public of the end of the informal comment period on TIR No. 2008-02, and that the Department would consider all informal comments and incorporate them into the final formal proposed film credit rules. DOTAX encouraged the public to submit comments on the proposed film credit rules.

DOTAX TIR No. 2009-05, "Advanced Notice of Proposed Administrative Rules Relating to the Taxation of the Motion Picture and Television Film Production Industry," was issued on September 17, 2009. TIR No. 2009-05 includes revisions to the original proposed film credit rules set forth in TIR No. 2008-02, after having considered the informal comments offered by the public. Similarly to TIR 2008-02, TIR 2009-05 states that it serves as DOTAX's policy and thus the state's policy regarding the film credit, and that taxpayers may rely upon the TIR to the extent taxpayers are authorized to rely upon it.

DOTAX TIR No. 2010-04, "Interpretation of "Qualified Production" for purposes of Tax Credit Claims under the Motion Picture, Digital Media, and Film Production Income Tax Credit, HRS §235-17," was issued on July 29, 2010. TIR No. 2010-04 provides further clarification on qualified productions including clarification that (1) separate and independent productions are entitled to separate and independent film credit claims, (2) a taxpayer may make two separate claims for the film credit for production of a pilot, followed by production of a series produced in Hawaii, (3) two or more entities contributing partially to a single final motion picture may qualify as separate qualified productions, and (4) a taxpayer may make multiple separate film credit claims for each "television special" filmed in Hawaii.

All Tax Announcements and Tax Information Releases are available to the public at DOTAX's website at *tax.hawaii.gov*. The Film Office's website at *filmoffice.hawaii.gov* lists TIR Nos. 2006-02, 2009-05, and 2010-04 under "Overview and Instructions". The Film Office and taxpayers have been using the TIRs and proposed film credit rules as guidance. The Film Office has never communicated to DOTAX that it was not able to administer the film credit due to lack of guidance. DOTAX provided substantial written guidance to taxpayers and to the film office regarding the film credit. DOTAX has provided ample support to the film office in answering specific questions not covered in DOTAX's written guidance. DOTAX believes it has provided adequate guidance to the film office to administer the film credit.

DOTAX submitted temporary film credit rules to the Governor for approval on May 20, 2016. The internal draft temporary film credit rules were provided for the Auditor's review during the course of the audit. The temporary film credit rules were approved by the Governor on September 8, 2016, and became effective on October 20, 2016. The temporary rules are effective for eighteen months. The temporary rules are available to the public at DOTAX's website at *tax.hawaii.gov*.

3. *Auditor's recommendation that DOTAX adopt administrative rules for section 235-17, HRS, including the following provisions:*

- *Require all productions to obtain independent review by a certified public accountant of production costs and provide the report to the film office prior to being certified for the tax credit.*

  There is no requirement in section 235-17, HRS, for production companies to obtain independent review of production costs in order to qualify for the film tax credit. It is DOTAX's understanding that the Executive Branches cannot mandate requirements that may cost money when not specifically authorized by statute.

  Section 18-235-17-15, temporary Hawaii Administrative Rules (HAR), provides a safe harbor for production companies that obtain independent review of their production costs. DOTAX does not oppose adding an independent review requirement to section 235-17, HRS.

- *Specify actions that satisfy the statutory requirement for productions to make reasonable efforts to hire local talent and crew.*

  DOTAX is not the subject matter expert on the film industry. DOTAX defers to the Film Office to redefine the evidence of reasonable efforts to hire local talent and crew, and will include the revision in the permanent film rules.

- *Require a more reasonable minimum financial or in-kind contribution and minimum education or workplace development effort from productions and consider basing the amount of such contributions on the amount of a production's qualified production costs.*

  DOTAX is not the subject matter expert on the film industry. DOTAX defers to the Film Office to make recommendations on the appropriate contribution amounts. DOTAX attempted to increase the contribution amounts in the temporary HAR from those amounts required in the proposed film credit rules in TIR No. 2009-05.

  Section 18-235-17-18, temporary HAR, changed the minimum financial contribution or in-kind contribution to 0.1% of production's qualified production costs or $1,000, *whichever is higher* (as opposed to "at a minimum, equal to *the lesser* or 0.1% of a production's qualified production costs or $1,000").

  Section 18-235-17-18, temporary HAR, increased the minimum requirement for educational programs to *8* hours from *5* hours.

- *Require productions to provide proof of the shared-card, end-title screen credit to the film office prior to being certified for the tax credit.*

  Section 18-235-17-16, temporary HAR, specifies how a production company may satisfy the shared-card, end-title screen credit requirement.

- *Require all productions to provide the following information as part of submitted post-production reports: (1) the number of Hawai'i resident and non-resident hires by category, such as above-the-line, below-the-line, and extras; (2) salary and wage information for resident actors, producers, directors, and other hires; (3) salary and wage information for nonresident actors, producers, directors, and other hires; and (4) any other information that DBEDT determines necessary to estimate the benefits of the tax credit.*

  Section 18-235-17-02, temporary HAR, requires that not later than ninety days following the end of the taxable year in which qualified production costs were incurred, all taxpayers must submit a production report to the film office that must include: (1) A sworn statement identifying qualified production costs incurred during the taxable year; (2) Data on the production as prescribed by the film office; (3) A detailed expenditure report with summary by department and category made on the form prescribed by the film office; (4) Documentation that the shared-card, end title screen credit requirement has been met; (5) A vendor list, crew list, and confirmation of efforts to hire local talent and crew; (6) Confirmation of education or workforce development contributions; and (7) Verification of compliance with the required Hawaii tax notice.

  As discussed in part 2 of DOTAX's response, DOTAX has informed the film office that they could require the information required in the above mentioned section of the temporary HAR before certifying qualified production costs on the authority provided in section 235-17(h), HRS.

- *Include a penalty for productions claiming the tax credit that do not meet the 90-day filing deadline to submit their written, sworn statements to DBEDT, similar to the stipulation for productions failing to prequalify for the credit by registering with DBEDT currently in section 235-17(f), HRS.*

  In addition to the requirements stated above, section 18-235-17-02, temporary HAR, provides that the film office <u>*shall not*</u> certify any production costs for which the detailed expenditure report is incomplete. The Hawaii film office will issue a certificate to the taxpayer certifying the amount of qualified production costs. In order to properly claim

the credit, the taxpayer must attach a copy of the certificate to the taxpayer's income tax return, along with any other required forms.

As discussed in part 2 of DOTAX's response, DOTAX has informed the film office that they could require information that would be required on the detailed expenditure report before certifying qualified production costs on the authority provided in section 235-17(h), HRS. Nevertheless, DOTAX has included the above provision in the temporary film credit rules. Additionally, DOTAX does not oppose adding a statement similar to section 235-17(f), HRS, to the statute regarding a detailed expenditure report or any other requirement the film office requests.

4. *Chapter 1: Overview of Hawaii's Film Tax Credit, Exhibit 1.3. Film Tax Credit – Number of Productions and Total Amount Claimed, 2011-2013.*

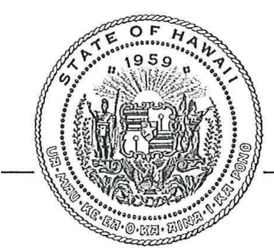
DOTAX believes that the State Auditor (Auditor) misread the data in DOTAX's Tax Credits Claimed by Hawaii Taxpayers (Tax Credit Report). It seems that the Auditor obtained the information in Exhibit 1.3 from Table A-1 and Table A-2 of DOTAX's Tax Credit Report (available at *tax.hawaii.gov*). The number of tax returns claiming the film credit is not the same as "number of productions receiving credit." For example, for tax year 2011, Exhibit 1.3 of the Auditor's report states that 128 productions received the film credit, whereas DOTAX reported that 106 individual income tax returns claimed the film credit, 19 corporate income tax returns claimed the film credit, and 3 fiduciaries and exempt organizations claimed the film credit, for a total of 128 tax returns.

A production company that is in the form of a partnership may have two or more partners. When the production company/partnership files a tax return and claims the film credit, the film credit is distributed to the partners, which claim the film credit on their individual or corporate income tax returns. The information in Table A-1 and Table A-2 of DOTAX's Tax Credit Report is based on number of tax returns. Therefore, DOTAX requests that the Auditor re-label its Exhibit 1.3 from "No. of Productions Receiving Credit" to something to the effect of "No. of Returns Claiming the Credit."

If you have any questions about this letter, please contact my office.

Sincerely,

Maria E. Zielinski
Director of Taxation



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DEPARTMENT OF BUSINESS, ECONOMIC DEVELOPMENT & TOURISM

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November 9, 2016

Mr. Leslie H. Kondo
State Auditor
Office of the Auditor
465 South King Street, Room 500
Honolulu, Hawaii 96813

Subject: DBEDT's Response to the Audit of Motion Picture, Digital Media, and Film Production Income Tax Credit

Dear Mr. Kondo:

The Department of Business, Economic Development, and Tourism (DBEDT) offers the following comments on the draft of the Audit Report on the Motion Picture, Digital Media, and Film Production Income Tax Credit (tax credit), dated October 28, 2016. The audit was conducted over the past year in cooperation with DBEDT's Hawaii Film Office and the Department of Taxation (DoTAX).

DBEDT agrees and supports some of the Auditor's recommendations to improve the economic benefits of the tax credit for Hawaii's residents. We recognize how important Hawaii's film industry is to building Hawaii's creative economy and the role the tax credit has in maintaining and creating jobs which strengthen Hawaii's film and media industry sectors. The tax credit must be extended beyond 2018 to continue to attract film productions, support infrastructure development and bring union jobs to Hawaii.

DBEDT agrees in whole, or in part, with the Auditor's findings and recommendations in the following areas:

- **Recommendation that Chapter 235-17, HRS, be amended to require a third-party review to verify that production costs qualify for the tax credit.**

  DBEDT agrees that the Legislature should amend Chapter 235-17 to require a third-party review and verification of qualified expenses for larger productions. DBEDT disagrees that all projects should be required to have a third-party review. Projects with a budget of less than $1M tend to be local, Hawaii-based productions and the costs associated with a third party audit would discourage these smaller productions from being made in Hawaii.

Mr. Leslie Kondo
November 9, 2016
Page 2

- **Recommendation to increase financial or in-kind contributions and education or workforce development requirements to more appropriately align with the amount of a production's qualified costs and the tax credit they may receive.**

  DBEDT agrees and supports the current language in the temporary Hawaii Administrative Rules in §18-235-17-18 (f) (1) and (2) that reads, "financial contributions to State public or charter schools totaling at least 0.1 percent of a production's qualified production costs or $1,000, whichever is higher." DBEDT believes that a sliding scale of contributions to workforce development and job creation will help grow local crew and talent.

- **Improvement of internal controls** in the administration of the tax credit process.

  DBEDT agrees that providing the Legislature with information on film productions applying for the tax credit requires the enhanced use of internal controls. To ensure more robust internal controls environment, DBEDT will implement the use of the compliance checklist on all production reviews.

  The Hawaii Film Office will be implementing a redistribution of work within the film branch to handle its tax credit duties. To assure proper tracking and reporting, as well as provide oversight of all the requirements of the tax credit, DBEDT believes an Accountant position is needed. In addition, an existing Economic Development Specialist V position will be re-described to a Film Industry Development Specialist VI to create a dedicated unit of two, full-time employees to handle all tax credit reviews and reporting.

  DBEDT will be migrating from Excel documentation to Microsoft Access data base documentation to improve data accuracy for reporting and tracking purposes.

- **Verification of end credits**.

  The Hawaii Film Office has already implemented a new verification procedure which includes the requirement that productions provide a screen shot of the end credit prior to submission of the Hawaii Production Report, during the post production process. Previously, the end credit was provided in the form of an image or in a DVD.
  DBEDT disagrees with several of the findings related to "inaccurate data, inflated data" and offers the following clarifications:

  - **Improve methodology and reporting to the Legislature.**

    Contrary to statements in the audit, the Hawaii Film Office has provided the costs of administering the tax credit to the Legislature in accordance with §HRS 235-17 and Section 4 of Act 89 SLH 2013, which provides in full:

235-17(i)(4) [DBEDT shall submit] a report to the legislature no later than twenty

days prior to the convening of each regular session detailing the non-aggregated qualified production costs that form the basis of the tax credit claims and expenditures, itemized by taxpayer, in a redacted format to preserve the confidentiality of the taxpayers claiming the credit.

SECTION 4. The department of business economic development, and tourism shall submit an annual report to the legislature no later than twenty days prior to each regular session beginning with the 2014 regular session. The report shall contain a cost benefit analysis of the motion picture, digital media, and film production income tax credit, including but not limited to the following: The total number of full-time, part-time and contract personnel on the payroll necessary to administer the motion picture, digital media and film production tax credit; and the average wage of each of the above personnel groups and total earnings for the year.

The department of business, economic development, and tourism shall report the data collected pursuant to section 235-17(i)(4), Hawaii Revised Statutes. The legislature may use the information to determine whether the tax credits are meeting the objectives of the motion picture, digital media, and film production income tax credit and this Act.

DBEDT is in compliance with these sections. The Film Office has included in each annual report to the Legislature the estimated dollar amounts of production expenditures. These estimated expenditures are derived from a production's submission of its Production Registration Form which is submitted pre-production and contains details such as the shooting schedule, number of local and off-shore hires and estimated production spend. Actual amounts do vary from the estimated amounts as some productions do not actually film in Hawaii. Estimates are not the basis for the tax credit. If a production does not film in Hawaii, no credit cost is incurred. The data is accurate based on filers' submissions available at the time the report to the Legislature is due. The annual report to the Legislature states that it is an 'estimated' report and provides economic impacts based on the estimated data from each production, as well as aggregate figures, as directed by law as noted above, and is due "twenty days prior to the convening of each regular session." As the majority of filers are on a calendar year basis for their tax year, they are not required to submit their Hawaii Production Report, which is filed post-production, with their "actual" spend until "90 days following the end of each taxable year." Therefore the legislative report is a combination of the data that is available to DBEDT twenty days prior to the beginning of the session (the majority of which are "estimated" as is noted in our reports to the Legislature, and a few "actual" production expenditures

based on the Hawaii Production Reports received in time to be included in our report to the Legislature).

- **Sidebar and Graphs.**

While DBEDT agrees that most of the graphics and sidebars in the report are helpful in providing the Legislature with information about the tax credit, DBEDT finds several include inaccurate information or provide misleading comparisons.

Exhibit 1.1, Chapter 1, page 3, Comparison of Selected States' Film Production Incentives, contains old information that is no longer accurate, and makes comparisons between tax credit percentage levels that apply to different kinds of allowed expenditures.

Exhibit 1.2, Ch. 1, page 5, Qualified Expenditures and Film Tax Credits Certified by Production Type for 2014 could be misleading. DBEDT recommends that the Qualified Expenditure amounts for each type of production be followed by the words, "Hawaii Spend" in order to clarify that the amount is not part of the tax credit.

Exhibit 1.3, Ch. 1, page 6, Film Tax Credit – Number of Productions and Total Amount Claimed, 2011 – 2013. The number of productions receiving credit for tax year 2011 is listed as 128. This figure likely reflects the number of tax returns filed, not the number of productions, as shown for the tax years 2012 – 2013. Comparing the number of returns with the number of productions results in a misleading comparison of the volume of productions.

Chapter 2, page 14, last paragraph, compares star salaries for out-of-state residents with extras' pay for day-work by in-state residents. Extras are paid a minimal fee for one or two days of filming, making the comparison of the two amounts one of apples to oranges. The more accurate comparison would be the wages of the "above-the-line" talent with the "below-the-line" union crew and technicians.

Chapter 2, page 15, "Star Salaries Skew Impacts." DBEDT requests that this sidebar be deleted from, or amended in, the final report. Although DBEDT understands the Auditor obtained permission from Disney to publish the photo of Johnny Depp, DBEDT is concerned that the actor and Disney may find the use of the photo, in the context in which it appears, objectionable. The salary information in the sidebar did not come from DBEDT. Also, the "assumption" that the percentage of the actor's wages for filming in Hawaii is one-half of the actor's total compensation is probably an over-estimate. If the sidebar is not deleted, DBEDT requests that the source of the salary information be cited and that it is made clear that such information did not come from DBEDT, and that a disclaimer be added to show that the "assumed percentage" is only a hypothetical.

State of Hawaii for the portion of their income that is attributed to their filming activities in Hawaii.

- **"Subsidizing" out-of-state businesses.**

  DBEDT disagrees with the Audit's findings regarding over-statement of "out-of-state" production expenditures. While DoTAX will speak to the relevance of including expenditures subject to use tax, DBEDT would like to point out that production companies that qualify for this tax credit are required to register to do business in the State of Hawaii through DCCA and are required to secure general excise tax licenses through DoTAX. The Film Office has instituted a process to verify that use tax is paid. When production companies purchase goods and/or services outside of the state is it usually because the item was unavailable in-state.

- **In conclusion -- Benefits of the tax credit program.**

  Having a tax credit program that has an industry reputation for being competitive and straightforward in its accessibility is critically important to Hawaii's ability to compete on a global scale to attract the new film and digital media business to Hawaii and support infrastructure development for Hawaii's media industries.

  The Legislature should view this tax credit as an essential tool that will allow Hawaii to grow this important industry. Given that 40+ U.S. jurisdictions and every major international filming destination has an aggressive tax credit program in place, Hawaii will experience a dramatic loss of business if the tax credit sunsets without an extension beyond 2018.

  By securing a legislative extension of the sunset date of the tax credit, Hawaii will be able to keep the pipeline full with productions that will infuse money into Hawaii's economy, create new jobs, and provide income for local residents.

DBEDT thanks the Department of Taxation, especially the Rules Officer, for its helpful guidance over the years, as DBEDT strives to provide the Legislature with the information it requires to assess whether the tax credit is achieving the Legislative intent.

DBEDT also thanks the Auditors for their patience and professionalism in the conduct of the audit and for their recommendations to improve the economic benefits of the tax credit for Hawaii's residents.

Sincerely,

Mary Alice Evans

for Luis P. Salaveria

STATE OF HAWAII
DEPARTMENT OF THE ATTORNEY GENERAL
TAX & CHARITIES DIVISION

October 17, 2016

CONFIDENTIAL: ATTORNEY-CLIENT PRIVILEGE

MEMORANDUM

TO: Ted Shiraishi
Rules Officer
Department of Taxation

CC: Damien A. Elefante
Deputy Director
Department of Taxation

Bryan Yee
Supervising Deputy Attorney General
Margaret Ahn
Deputy Attorney General
Commerce and Economic Development Division

THROUGH: Russell A. Suzuki
First Deputy Attorney General

FROM: Cynthia M. Johiro
Deputy Attorney General
Tax and Charities Division

RE: Analysis of Hawaii Revised Statutes § 235-17 (the Hawaii Film Credit)

I. Introduction

You requested advice on the interaction of the State of Hawaii general excise tax, Hawaii Revised Statutes chapter 237, et seq. and the use tax, Haw. Rev. Stat. ch. 238, et seq. Specifically, Haw. Rev. Stat. § 235-17 (Supp. 2015) (the "Film Credit") defines "qualified production costs" as costs that must be subject to income tax under ch. 235 or general excise tax under ch. 237. The State Auditor is questioning the allowance of the use tax under ch. 238 as a qualified production cost.

II. Facts

The film credit defines "qualified production costs" as costs that must be subject to income tax under ch. 235 or general excise tax under ch. 237. The State Auditor is questioning the allowance of the use tax under ch. 238 as a qualified production cost because it is not enumerated as a production cost in the Film Credit. The Department of Taxation's (the "Department") Tax Information Releases[1] and temporary rules allow costs subject to the use tax to qualify for the Film Credit. However, because the use tax is not specifically mentioned as an allowed cost in the Film Credit, the Auditor believes that costs subject to the use tax should not be allowed. The Department contends that disallowing costs subject to the use tax could violate the Commerce Clause and/or the Equal Protection Clause. The Auditor's response was that all laws passed by the Legislature and Governor are presumed to be constitutional.

Similarly, insurance premiums are mentioned specifically in the definition of qualified production costs, but are not subject to income or the general excise taxes. The Auditor's position is that insurance premiums should be excluded. See Haw. Rev. Stat. § 235-17(l).

III. Questions Presented

Should use taxes, even if not specifically mentioned in the film credit, be allowed as qualified production costs? Should insurance premiums be allowed as qualified production costs?

IV. Short Answers

Yes. The general excise tax and the use tax are complementary; both the use tax and the general excise tax, whether taxed to the buyer or seller, uniformly raise the final cost of the product being bought or sold by an equivalent amount. They are thus, by definition, complementary taxes. *CompUSA Stores LP v. Department of Taxation*, 128 Hawaii 116, 284 P.3d 209 (2011).

Yes. Reading the plain language of the statute, insurance premiums are clearly qualified production costs.

[1] Tax Information Release Nos. 2002-4 and 2009-2.

V. Discussion

A. Considering the General Excise Tax Without the Use Tax as a Cost May Offend the Commerce and/or Equal Protection Clauses.

It is well-settled in this jurisdiction that the general excise tax and the use tax are constitutionally bound to each other. The Hawaii Supreme Court has unequivocally upheld the constitutionality of the Hawaii use tax. In *Matter of Hawaiian Flour Mills, Inc.*, 76 Hawaii 1, 13, 868 P.2d 419 (1994), the court held that:

> HRS § 238-2 (1985) provides for "an excise tax on the use in this State of tangible personal property which is imported . . . for use in this State." The general theory behind such a tax is "to make all tangible property used or consumed in the State subject to a **uniform tax burden irrespective of whether it is acquired within the State, making it subject to the [general excise] tax, or from without the State, making it subject to a use tax at the same rate**." *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 66 [] (1963). **In the absence of a use tax that complements a GET, sellers of goods acquired out-of-state theoretically enjoy a competitive advantage over sellers of goods acquired in-state**: not being subject to the GET, out-of-state products would be less expensive than in-state products, the prices of which would presumably reflect some pass-on of the GET. . . .

Id. at 13, 868 P.2d at 431 (emphases added).

The *Matter of Hawaiian Mills Inc.* holding derives from the court's prior determination that Haw. Rev. Stat. § 238-2 was enacted to complement the general excise tax. In *Matter of Habilitat*, 65 Haw. 199, 648 P.2d 1126 (1982), the Hawaii Supreme Court determined that the use tax is a complementary tax that "buttresses" the general excise tax, for the purpose of "leveling the playing field" and erasing the competitive advantage that out-of-state merchants, outside of the State's taxation jurisdiction, might have over local merchants. As the *Habilitat* court recognized, Haw. Rev. Stat. § 238-2 imposes a levy "on the use in this State of tangible personal property which is imported, or purchased from an unlicensed seller, for use in this State." The tax buttresses the general excise tax as it is designed to prevent the avoidance of excise taxes through direct purchases from the mainland. Its ultimate purpose is to remove the competitive advantage an out-of-state wholesaler or retailer would otherwise have over a seller subject to the payment of State excise taxes. . . . [T]he enactment of the use tax in 1965 was prompted in part by the "substantial volume of sales by unlicensed sellers to local buyers (that) . . . escape(d) taxation because such sales . . . (were) accomplished directly between buyer and seller without the services of an intermediary." Id. at 209, 648 P.2d at 1133-34 (citing H. Conf. Comm. Rep. No. 21, in 1965 House Journal 839, 843).

More recently, the Hawai'i Supreme Court upheld the State's use tax assessment against a taxpayer by recognizing that:

> The use tax is closely connected with Hawaii's general excise tax (GET). . . . The GET places a 0.5% tax on the business of manufacturing and wholesaling in Hawai'i, resulting in a price differential between the products made and sold wholesale locally and the same products made and sold wholesale on the mainland. . . . **"[i]n the absence of a use tax that complements a GET, sellers of goods acquired out-of state theoretically enjoy a competitive advantage over sellers of goods acquired in-state**: . . . out-of-state products would be less expensive than in-state products, the price of which would presumably reflect some pass-on of the GET."

CompUSA Stores LP, 128 Haw. at 122, 284 P.3d at 215 (citing references omitted) (emphasis added).

The use tax and general excise tax operate in perfect symmetry. Both apply to personal property being sold or used in Hawaii; the use tax is an excise tax that applies to goods purchased out-of-state, and the general excise tax applies to goods purchased in-state. Use taxes are "prototypical" compensatory taxes.[2]

The United States Supreme Court, in fact, has recognized that a general excise tax (paid by the seller) and a sales tax (paid by the buyer) achieve the same result of taxing the transfer of property:

> **There is the same practical equivalence whether the tax is on the selling or the buying phase of the transaction. . . . Each is in substance an imposition of a tax on the transfer of property.** In light of our recent decisions it could hardly be held that Indiana lacked constitutional authority to impose a sales tax or a use tax on these transactions. But if that is true, a constitutional difference is not apparent when a 'gross receipts' tax is utilized instead.

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[2] In *Oregon Waste Systems, Inc.*, the Supreme Court acknowledged prior decisions upholding use taxes on "products purchased out of state," that are equivalent to a tax levied on goods purchased in-state, as "prototypical" compensatory taxes. See *Oregon Waste Systems, Inc.*, 511 U.S. at 105 ("The prototypical example of substantially equivalent taxable events is the sale and use of articles of trade.") The specific tax at issue in *Oregon Waste Systems, Inc.* was not an equivalent use tax, however. It was a tax which imposed a $2.50 per ton surcharge on the disposal of waste generated in other states, and a $0.85 per ton surcharge on the disposal of waste generated within Oregon. Id.

International Harvester Co. v. Dept. of Treasury of State of Ind., 322 U.S. 340, 348 (1944) (emphasis added, citations omitted).

As a practical matter, the general excise tax imposed on a local Hawai'i seller is either directly passed on to the buyer or incorporated into the base price of the product sold, resulting in the buyer paying a higher cost. The end result is that the buyer ultimately must cover the combined cost of the product and the tax. The use tax "levels the playing field" for local Hawaii merchants because it effectively raises the cost of out-of-state goods by an amount equivalent to the general excise tax. The goal behind the use tax is to make the final cost of out-of-state goods competitive with equivalent in-state goods.

The United States Supreme Court stated in a case arising from a Hawaii tax law that the cardinal rule of Commerce Clause jurisprudence is that "[n]o State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.'" *Bacchus Imports Ltd. v. Dias*, 468 U.S. 263, 268 (1984), citing *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 329 (1977). In *Bacchus*, the United States Supreme Court struck down a Hawaii law that provided an exemption from the liquor tax for liquor produced in the State. Without an equivalent use tax, then, the Film Credit would favor local taxpayers.

B. The Director is Statutorily Empowered to Construe the Tax Laws.

The Director is statutorily empowered to construe the tax and revenue laws. See Haw. Rev. Stat. § 231-3(3) (2001).[3] The Hawaii Supreme Court has stated that:

> [w]e have recognized the wisdom of a well established rule of statutory construction that, where an administrative agency is charged with the responsibility of carrying out the mandate of a statute which contains words of broad and indefinite meaning, courts accord persuasive weight to administrative construction and follow the same, unless the construction is palpably erroneous. (Citations omitted.)

Aio v. Hamada, 66 Haw. 401, 406-407, 664 P.2d 727, 731 (1983) (quoting *Treloar v. Swinerton & Walberg Co.*, 65 Haw. 415, 424, 653 P.2d 420, 426 (1982)), quoting *Waikiki Resort Hotel v. City & County*, 63 Haw. 222, 242-243, 624 P.2d 1353, 1368 (1981); see also *Nihi Lewa, Inc. v. Dep't of Budget and Fiscal Servs.*, 103 Haw.

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[3] The Department shall have the duty and power to "construe the tax and revenue laws, the administration of which is within the scope of the department's duties, whenever requested by any officer acting under those laws, or by an interested person;"

163, 166-167, 80 P.3d 984, 987-988 (2003); *Alakai Na Keiki, Inc. v. Hamamoto*, 125 Hawai'i, 200, 204, 257 P.3d 314, 317 (Haw. App. 2011) (same). Furthermore,

> "[o]ne of the most significant aids of construction in determining the meaning of revenue laws is the administrative interpretation given such acts by the agency that is responsible for its administration and enforcement. If the interpretation is not irrational or unreasonable it will be upheld."

Norman J. Singer, Sutherland's Statutory Construction, Volume 3A §66:4 (6th Ed. 2003) (emphasis added).

Therefore, after careful review of the nature and the legislative intent in enacting the use tax, the Director decided that the general excise tax could not be considered as a qualified production cost without the use tax, given the above-discussed constitutional concerns. See Tax Information Release 2002-4. The Director's interpretation of the inclusion of the use tax as a qualified production cost is also consistent with the Hawaii Supreme Court's instruction that "statutory language must be read in the context of the entire statute and construed in a manner consistent with its purpose." *In the Matter of the Tax Appeal of Spirent Holding Corp.*, 121 Hawaii 220, 227, 216 P.3d 1243, 1250 (2009).

C. The Film Credit Specifically Enumerates Insurance Premiums as Qualified Production Costs.

The definition of "qualified production costs" in Haw. Rev. Stat. § 235-17(l), expressly includes a category called "insurance and bonding." Accordingly, the inclusion of insurance premiums should not be questionable given the specific enumeration of this expense as a qualified production cost. Consistent with *In re Tax Appeal of Lower Mapunapuna Tenants Ass'n*, 73 Haw. 63, 828 P.2d 263 (1992) (citation omitted) "[d]eparture from the plain and unambiguous language of the statute cannot be justified without a clear showing that the legislature intended some other meaning would be given the language." Id. at 68, 266 790 P.2d at 266. The Director does not raise any constitutional concerns as to the inclusion of insurance premiums as qualified production costs, contrary to the Auditor's proposed treatment of use taxes; moreover, her interpretation of insurance premiums as qualified production costs is within the plain reading of the Film Credit. The Hawaii Supreme Court has stated that "the fundamental starting point for statutory interpretation is the language of the statute itself. Second, where the statutory language is plain and ambiguous, [its] sole duty is to give effect to its plain and obvious

> meaning." *Awakuni v. Awana*, 115 Hawaii 126, 133, 165 P.3d 1027, 1034 (2007).

VI. Conclusion

The inclusion of the use tax as a qualified production cost in spite of its exclusion from the plain language of the statute and the inclusion of insurance premiums in the plain language of the statute appear to be proper. The Director's treatment of both costs are grounded in well-established case law. "In construing each individual part of the statute, the court must consider the statue as a whole to ensure that all parts produce a harmonious and sensible whole." *State v. McKnight*, 131 Haw. 379, 390, 319 P.3d 298, 309 (2013). To avoid subjecting the Film Credit to constitutional challenge, the Director has correctly recommended the inclusion of the use tax as a qualified production cost. The Director appears to be appropriately reading the plain language of the Film Credit in including insurance premiums.

APPROVED:

Douglas S. Chin, Eq.
Attorney General, State of Hawaii

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