Office of the
State Auditor

Payoffs AND Layoffs

The High Cost of Business Subsidies

A Compliance Audit of the Vermont Economic Advancement Tax Incentives Program, administered by the Vermont Economic Progress Council and the Vermont Tax Department

Elizabeth M. Ready
Vermont State Auditor
December 30, 2004

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VERMONT STATE AUDITOR'S OFFICE
Montpelier, Vermont 05633-5101

December 30, 2004

Honorable Governor James H. Douglas
Members of the 2005-2006 Vermont General Assembly
Senator Peter Welch, President Pro Tempore
Rep. Gaye Symington, Speaker-Elect of the House of Representatives
Rep. Walter Freed, Speaker of the House of Representatives

Dear Colleagues:

We have conducted a compliance audit of the Vermont Economic Advancement Tax Incentives program (EATI) as required by 32 V.S.A. §163(12).

STRONG ACTION IS NEEDED

Our audit found that:

- **In the time period reviewed, 21 companies were allowed $20.9 million in tax credits based on promises to create 3,478 new jobs.**
- **Instead these companies created only 226 net new jobs, or 6.5% of the jobs promised.**
- **The average direct cost of this public expenditure is $92,733 per net new job.**
- **Six of the 21 companies *exceeded* their job creation targets, averaging 60 net new jobs each, but these gains were offset by large job losses at other companies.**
- **Fourteen of the companies *did not meet* their job creation goals.**
- **One company *met* its job creation goals.**
- **Eight of the 21 companies *reduced* jobs over the period reviewed yet were allowed a total of $8.1 million in tax credits, $4.6 million of which has already been applied to reduce taxes.**

We recommend that the Legislature:

- simplify and restructure the Vermont Economic Advancement Tax Incentives (EATI) program;
- compel the Tax Department and VEPC to immediately disallow and recapture more than $8 million in tax credits allowed to eight companies during a time they reduced employment;
- cap the program's annual draw-down of State revenues and require the Administration to account for its future liabilities on the State's financial statements; and
- place a moratorium on all new awards until these measures are fully accomplished.

A HISTORY OF NON-COMPLIANCE

This is the third biennial compliance audit conducted by this Office pursuant to Title 32 V.S.A. §163(12). With each audit, the findings have become more significant and the economic impacts to the State's revenues more dramatic.

A June, 2000 report by this Office cited numerous internal control failures with the EATI application and award process that exposed the State to substantial tax expenditures for projects that might have occurred without subsidies. The report, by then-Auditor Edward Flanagan, faulted the program for awarding tax credits for economic activity that occurred before the company's application, for authorizing larger-than-necessary tax credits, and failing to substantiate critical application information, among other findings.

In the FY 2002 Report on Compliance and Internal Control Over Financial Reporting, KPMG and this Office noted that Department of Taxes' lack of internal controls to fully verify tax credit claims constituted a material weakness adversely affecting the State's ability "to record, process, summarize and report financial data consistent with the assertions of management in the basic financial statements."

In 2003, this Office found that the Tax Department allowed $24 million of tax credits to be claimed without fully verifying that the promised economic activity, upon which the credits were based, had occurred. Then-Commissioner Richard Mallary, in his response to the report stated: "The clear legislative intent of Act 71 was to make available certain tax credits for entities that performed specified activities promoting economic development … The Department shall proceed from this point forward on the basis that the language in award letters made all awards conditional, and that the inherent powers of the Department allow it to reduce or deny credits awarded by VEPC."

Now, in 2005, the program continues to lack meaningful performance review for many recipients and has promised many jobs while creating few at a staggering public cost. In addition, the lack of controls over the tax incentives program has resulted in eight companies taking $8 million in tax credits during a period when they actually ***reduced*** jobs.

THE PROMISE OF ECONOMIC DEVELOPMENT

The Vermont Economic Advancement Tax Incentives (EATI) was designed as a performance-based program to add high-paying new jobs and new economic investments to the economy by awarding income tax credits to qualified firms, and property tax awards to municipalities supporting selected projects.

The program is jointly administered by the Vermont Economic Progress Council (VEPC) which reviews applications and authorizes tax credits, and the Tax Department which reviews tax returns and allows or disallows tax credit claims.

The EATI program was enacted in 1998 and 151 companies now have authorizations for more than $104 million in potential tax credits.

Income tax credits are dollar-for-dollar reductions in taxes due the State for corporate income taxes. However, some of the approved companies are subchapter "S" Corporations which pass the benefit of the tax credits to individual owners and shareholders to reduce personal income tax liabilities.

Of these 151 entities, 55 have been allowed $29.5 million in income tax credits by the Tax Department as of June 30, 2004.

These companies and individuals have used $13.6 million of the $29.5 million to reduce State taxes; the remaining $15.9 million has been carried forward for possible use in future tax years. A

tax credit that is carried forward is typically available for at least 5 years after the award period has expired.

Our task, according to statute, is to "biennially audit the economic advancement tax incentives program established under chapter 151, subchapter 11E of this title to determine compliance with that subchapter and all other applicable statutes and regulations."

The Reality: A Failure to Verify Performance

1. Many jobs were promised, but few were created.

We reviewed the actual job creation performance of 21 selected companies that had been allowed substantial tax credits in recent years. We noted the number of jobs existing at the time of the company's award, the number of jobs promised by each company through December 31, 2003 or latest report, and the actual number of jobs at the companies as of December 31, 2003 or latest report.

The 21 entities promised to create 3,478 new jobs in the time period reviewed, but created only 226 net new jobs, or 6.5% of the jobs promised. Six of the 21 companies *exceeded* their job creation targets, averaging 60 net new jobs each, but these gains were offset by job losses at other companies. Fourteen of the companies *did not meet* their job creation goals. One company *met* its goal.

2. Companies have earned credits while failing to create promised jobs, and even while *reducing* jobs.

As a group, the 21 companies selected for review were allowed $18.8 million in EATI income tax credits and $2.1 million in municipal awards linked to two projects since the program began, for a total of $20.9 million – about 65% of the total allowed in the program to date.

We found numerous instances where companies claimed income tax credits but clearly did not meet the performance targets they had promised to achieve in their initial applications. In addition, companies were allowed millions in tax credits for investments in capital equipment, construction, or research and development in years when they did not add jobs, or in some cases, when companies reduced employment.

Eight of the 21 companies reduced jobs over the period reviewed, yet were allowed a total of $8.1 million in tax credits.

3. Thus, new net jobs have come at a high price.

Job creation has been weak, but expenditures have been high. The 226 net new jobs created by the 21 companies come at a potential cost of $20.9 million in direct public expenditures, an average of $92,733 per net new job. This figure assumes that all the income tax credits earned by these companies to date are eventually applied to reduce State taxes. It also assumes that none of the 226 net new jobs would have been created without the tax incentive award, which is unlikely as our report discusses later.

4. Off-budget expenditures create financial risk for the State.

Tax credits are really budget expenditures and thus taxpayers pay a real cost for the tax incentive program. However, these expenditures are not reviewed, debated or approved each year by the Legislature and the Governor. One of the realities of the State budget is that whenever a group of taxpayers receives special assistance to reduce taxes, others must pay more in tax, or lose money in other spending.

Financial risk is heightened by the fact that there is no cap on the amount of credits that can be awarded by the Economic Progress Council in a given year. Annual authorizations have ranged from a low of $5 million to a high of $36 million.

5. VEPC does not provide adequate scrutiny in assessing "but for" statements of company officials applying for tax credits, thereby exposing the state to millions of dollars in unnecessary awards.

The determination of whether or not an applicant's intended investment would proceed in the absence of a State subsidy is called the "but for" test. For an award to be granted, companies must state – and the Council must agree – that "but for" the incentive, the investment would not occur in whole or in part.

The "but for" test is critical in determining any fiscal benefits to the State because any State expenditure to "incent" an investment that would occur without the incentive would be an unnecessary expenditure. It is a poor use of taxpayers' dollars to subsidize a project that would likely occur without the subsidy.

The Vermont Economic Progress Council's approach to the "but for" test is limited. The Council does not review financial statements, business plans, or tax records to assess the financial necessity of a tax credit authorization. It does not ask applicants for specific alternate development plans should the application be denied. The Council has thoughtful, experienced business and development professionals, but no members representing the Joint Fiscal Office or the State treasury.

6. Employees are struggling to keep up with the time-consuming administrative demands of this complex program.

Both the Tax Department and the Vermont Economic Progress Council have made some improvements in administering the program by adopting new procedures, and in the Tax Department's case, by forming a five-person team to review EATI returns. Both the Tax Department and VEPC have seen their workloads increase due to the complexity of the statute and program operations, and to the increasing number of companies and credit categories in the program.

KEY RECOMMENDATIONS: VERIFY, SIMPLIFY!

Our recommendations, outlined in more detail throughout the report, include the following:

1. **The Tax Department and VEPC should immediately disallow and recapture more than $8 million in tax credits taken by eight companies during a time they reduced employment.**
2. **The Legislature should review the cost-effectiveness of this program, simplify it, and place a moratorium on new awards until adequate controls are in place to ensure that companies meet performance expectations before earning credits.**
3. **VEPC should provide performance expectation documents for all companies that received awards prior to July 1, 2000 within 60 days.**
4. **The Legislature should annually authorize an award cap for this program as part of its evaluation of economic and budget factors.**
5. **The Legislature should eliminate the "but for" test as the basis for fiscal cost measurement in the EATI program.**
6. **The Legislature should discontinue all credits except those that can be explicitly measured by the cost-benefit model and focus the EATI program on just two areas – new jobs and investments – to help ensure that the program is truly performance-based.**

THE TAX DEPARTMENT STEPS UP

The circular shifting of responsibility between the Tax Department and VEPC has created an environment where companies routinely claim tax credits while neither agency fully assumes its role in completing meaningful performance verifications. For example, the agencies' responses to this report (See Appendices A and B) offer a number of examples where one agency disagrees with or blames the other. The result is that companies which have failed to create promised jobs and economic activity have taken millions in tax credits.

The bright spot, however, comes in the response of Tax Commissioner Thomas Pelham who joins us in recommending that the program be restructured and simplified. Pelham, in his response to the draft report, states: "The time has come for the incentives to be restructured from the ground up with better targeting and simpler delivery of the benefits, eliminating the complexities of the current program."

Pelham plans to propose simplifying the program by allowing a single tax credit tied to a company's payroll. "We want these credits to be used to increase jobs and increase the quality of jobs. And if the number of jobs at a company is growing, and the pay is growing, then we can see that through their payroll," he recently stated. The Legislature will need to take a hard look at Commissioner Pelham's proposal.

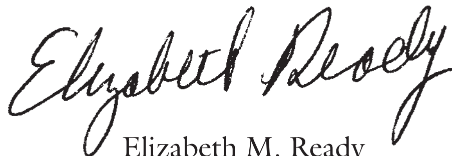
After six years many legislative modifications the present program is clearly not working as intended. We hope this report and the Commissioner's forthcoming recommendations will help to form the basis of a new and simpler tax incentive program that will accomplish the goal of creating jobs in a manner that is verifiable, fair, cost-effective and more accountable than the current program.

"The time has come for the incentives to be restructured from the ground up with better targeting and simpler delivery of the benefits, eliminating the complexities of the current program."

— Tax Commissioner Thomas Pelham

We appreciate the timely and professional assistance we received from Economic Progress Council members and staff, and from the Department of Taxes and its staff, in conducting this compliance audit. Our audit team thoroughly respects the excellent effort these people are making to administer a complex program.

Sincerely,



Elizabeth M. Ready
Vermont State Auditor

Tax Credit Glossary

This State Auditor's Office uses the following definitions in this report:

Tax credits may be AWARDED. This refers to the authorization or awarding of a certain amount of tax credits by the Vermont Economic Progress Council to an approved company.

Tax credits may be CLAIMED. This refers to the amount of tax credit a company files for in its company tax return and which is passed through pro rata to be applied on its owners' returns. (See Appendix D for the tax return schedules used to claim EATI credits.)

Tax credits may be EARNED OR ALLOWED. This refers to the amount of tax credit authorized by the Tax Department. When a tax credit is EARNED it has been properly justified and calculated in a tax return, accepted and ALLOWED by the Tax Department.

Tax credits may be APPLIED. This refers to the actual amount of earned tax credits that is used by the taxpayer to reduce Vermont State income taxes in a given tax year.

Tax credits may be CARRIED FORWARD. This refers to the amount of tax credits which have been earned that are not applied against tax liability in a given tax year. The amount carried forward can be used in a later year to reduce a tax liability.

Tax credits may be INACTIVE. This refers to awards from the Economic Progress Council that have been rescinded or cancelled for various reasons such as cancellation of the proposed project, non-compliance with program rules, business closure, etc.

Tax credits may be DISALLOWED. This refers to tax credits that are unavailable to the taxpayer due to a failure to achieve performance expectations, failure to file timely reports required by statute, and/or other reasons.

Tax credits may be RECAPTURED. This refers to tax credits earned by companies, allowed by the Tax Department, and applied to reduce a tax liability that must be repaid to the State. Statutes authorize recapture for 1. failure to conform to performance expectations, reporting requirements, and other program rules; or 2. failure to maintain certain employment levels.

Abbreviations:

VEPC: Vermont Economic Progress Council

EATI: Economic Advancement Tax Incentives Program

Findings, Discussion & Recommendations

Finding 1

The Tax Department and VEPC lack adequate controls to enforce key performance provisions of the Economic Advancement Tax Incentives (EATI) program, as required by statute.

Due to the absence of these controls, we found that 21 companies promised to create a total of 3,478 permanent new jobs and were allowed $20,957,578[1] in tax credits in the time period reviewed. The companies created 226 new jobs – 6.5% of the promised total.

Eight of the 21 companies reduced jobs in the time period reviewed, yet were allowed a total of $8,092,210 in tax credits.[2]

The average direct public expenditure for the 226 jobs created is $92,733 per job.[3]

Discussion

Of the 55 companies that have been allowed a total of $29.5 million in income tax credits since the EATI program began in 1998, we chose to review 21 companies which were allowed substantial tax credits in the 2002 and 2003 tax years.[4]

These companies as a group were allowed $18.8 million in EATI income tax credits and $2.1 million in municipal awards since the program began, for a total of $20.9 million – about 65% of the total allowed in the program to date.

We reviewed the actual job-creation performance of these companies to determine if the program was meeting its statutory goals of creating permanent high-paying full-time jobs with as little cost to the State as possible.

Summary of job creation[5]

Because the prime goal of this tax credit incentive program is to spur the creation of new jobs, we found the results somewhat surprising:

These 21 firms promised they would create 3,478 net new jobs in the time period we reviewed, but created only 226 net new jobs, or 6.5% of the jobs promised.

The direct public expenditure for these 226 new jobs is $92,733 per job.

Six of the 21 companies exceeded their job creation targets, averaging 60 net new jobs each, but these gains were offset by job losses at other companies. Fourteen of the companies did not meet their job creation goals. One company met the goal.

Eight of the 21 companies reduced jobs over the period reviewed, yet were allowed a total of $8,092,210 in tax credits.

These findings, based on current Tax Department information, clearly indicate that this program as currently administered is not performance-based, and is significantly more expensive than previously thought.

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[1] This includes $18.8 million in income tax credits and $2.1 million in linked municipal awards. See Finding 5 for more discussion on municipal awards.

[2] Some of the eight companies may have added jobs during the review period, but they reported fewer Vermont employees at the end of the time period reviewed than existed prior to their VEPC awards.

[3] This is calculated by dividing earned credits and exemptions of $20.9 million by 226 jobs, and assumes all earned credits are eventually applied. Other indirect costs and benefits were not analyzed.

[4] We selected 100% of entities that were allowed over $31,000 in income tax credits for the 2002 and 2003 tax years by the Tax Department as of June 30, 2004. Because many of these tax credits originated prior to 2002, and EATI recapture provisions are affected by prior activity, we examined company promises, company performance and the processing of these awards from their origination dates to the latest period for which reliable data were available.

[5] Due to confidentiality agreements and state law, we can only discuss these findings in the aggregate, without mentioning details that might lead to the inappropriate disclosure of a company's confidential financial or tax return information.

New Jersey: A flawed job creation program

Researchers at the non-profit New Jersey Policy Perspective reviewed that state's Business Employment Incentive Program (BEIP) last year. Through the BEIP award program, enacted in 1996 and re-shaped in 2003, the state has given more than $60 million in cash grants to companies that either relocate to New Jersey or expand their operations in the state.

The New Jersey Economic Development Authority (EDA) administsers the program and must determine that a business's decision to relocate or expand will "result in a net increase in new employment at the project," and that the incentive program is a "material factor" in the decision to locate or expand in New Jersey. Applications are rejected if a company has already purchased land or a building because at that point the incentives are no longer considered a "material factor" in the company's decision.

The program does not provide tax credits, but offers cash grants for up to 10 years equal to between 10 and 80 percent of the amount that a company withholds from its employees for the state's Gross Income Tax payments. A certain number of employees have to be hired before applying for the award payment. Like Vermont's EATI program, the law allows the state "clawback" rights to reclaim incentives paid if a company does not abide by its incentive agreement.

The report cited a number of problems with the program:

- there is growing evidence that the incentive program is not meeting original goals;
- incentives are only of marginal importance to location or expansion decisions;
- the number of people a company promises to hire often bears no resemblance to what actually happens;
- a company doesn't have to hire all the people specified in the grant application before it can receive money from the state;
- companies have received grants even though they laid off employees at the project site or other state location;
- company applications do not require information on state taxes paid by the company or compensation amounts for the CEO and other top executives, thus increasing the risk of providing grants to companies not paying the state's Corporate Business Tax, or to companies in a strong financial position which does not merit assistance from taxpayers.

The report recommends that:

- the state should study alternative economic development expenditures that might produce better results;
- the state should disclose, monitor, audit and evaluate who gets what awards, and what the state gets in return;
- grants should be subject to annual budget appropriations in the Legislature;
- companies should be allowed to receive either an incentive grant for new jobs or a local property tax exemption – but not both;
- businesses that incorporate outside the U.S. in order to avoid paying taxes should not receive the incentives;
- the state should produce a Unified Development Budget that would annual aggregate all forms of spending by state government on economic development;
- grants should be available only to businesses locating in economically distressed areas; and
- the state should produce a detailed study that includes evaluation of the program's effectiveness in creating new jobs and its impact on state revenues.

The report closes by questioning the central rationale of the program, that companies would not come to New Jersey "but for" the BEIP grant and that therefore the program is fiscally neutral.

See the full report, "Taking Care of Business: Does It Cost Too Much?" at: www.njpp.org/RPT_takingcare.html, or call 609-393-1145 to request a copy.

Determining net new jobs

For each company, we considered:

1. the number of jobs in place at the time of the application;

2. the number of new jobs promised during the period reviewed (for most companies this was from the beginning of the award through December 31, 2003); and

3. the number of full-time jobs at the conclusion of the period reviewed (for most companies this was December 31, 2003).

The data on jobs at the time of application, and projected new jobs to be created, came from the companies' confidential applications for tax credits.

The data on jobs created during the award period, and existing jobs as of December 31, 2003 or latest report, came from three primary sources[6] :

A. the tax return schedule for claiming the Small Business Investment Credit (now called the Capital Investment Tax Credit) where the company must indicate the number of Vermont-based jobs;

B. the company's yearly Activity Report which is required to be submitted to VEPC and the Tax Department with its tax return; and

C. data from the Tax Department's internal income tax withholding filings by entities and data from the Department of Employment and Training.[7]

Job cuts seriously affect the overall economic impacts of the program. One reason is that the cost-benefit model used in the program to determine the company's total award amount – and the fiscal benefits to the State – assumes that permanent jobs are created over a 7-year period. Thus, when jobs are cut during the 5-year award period – and even after that – the State does not receive its full share of benefits, even though it might be paying the full or a disproportionate share of the cost of the tax credits. Some companies received EATI credits for payroll growth from jobs created in one year, but then eliminated these jobs in subsequent years with no penalty or award adjustment. This fact adds to the cost of the program and inappropriately rewards companies that have reneged on their promises.

Importance of monitoring

The principles behind the EATI program are simple. A company promises to create a specified number of permanent new jobs or a specified amount of new economic activity in return for credits against its State income tax liability. Theoretically the credits can only be allowed, or "earned," and then used against the company's tax liability after the new jobs or new economic investments are actually in place, and stay in place. The Legislature understood that tax credits have a similar effect upon the State's income statement as an expenditure. It is akin to when a bridge is built or a service is rendered, and the State pays the bill. Once jobs are created or economic activity is accomplished, the tax credit is earned or taken and the amount of revenue owed to the state is reduced. In the first case the State is buying goods and services, in the second case it is "buying" job creation.

Monitoring company performance lies at the heart of the EATI program. The theory is that since all of an applicant's promised economic activity is new, and would not have occurred without the tax credits, the program is therefore generating new net revenues for the State. The tax credits, in theory, simply reduce the amount of new revenue coming to the State and provide for new net economic growth for the State.

Therefore the control point that safeguards the State's revenues is accurate verification of every company's performance *before* the tax credits are allowed. This verification must also be used to adjust the tax credits to reflect actual performance. This is not occurring.

If strong controls are not in place to monitor

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[6] In many cases, companies provided conflicting data from year to year, and between tax returns and Activity Reports.

[7] Withholding information was occasionally verified by the Tax Department using Department of Employment and Training figures which include part-time workers. Part-time employees could swell a firm's roster of workers, but the numbers do provide the Tax Department with a reliable indicator of how a company's employment is trending.

[8] State Auditor's Office (SAO) analysis of data from the Tax Department and the company's application to VEPC.

performance, companies that did not create jobs or economic activity can take tax credits, thus exposing the State to revenue loss without returning any economic benefit.

NONPERFORMANCE WIDESPREAD

Our review of 21 companies shows that nonperformance has been widespread, yet companies have been allowed millions in tax credits.

Contrary to §5930a(m)(1)(A-C), the Tax Department allowed tax credits when companies:

- did not "comply with all performance expectations upon which the award was conditioned;"
- did not supply essential information, such as employment numbers and wage levels, as required by statute;
- failed to file timely annual Activity Reports as required by statute;
- claimed research and development (R&D) investment credits, capital investment credits, and/or other credits, but did not add jobs, or even *reduced* jobs; and
- failed to certify they met minimum employment levels for that year, as required by statute.

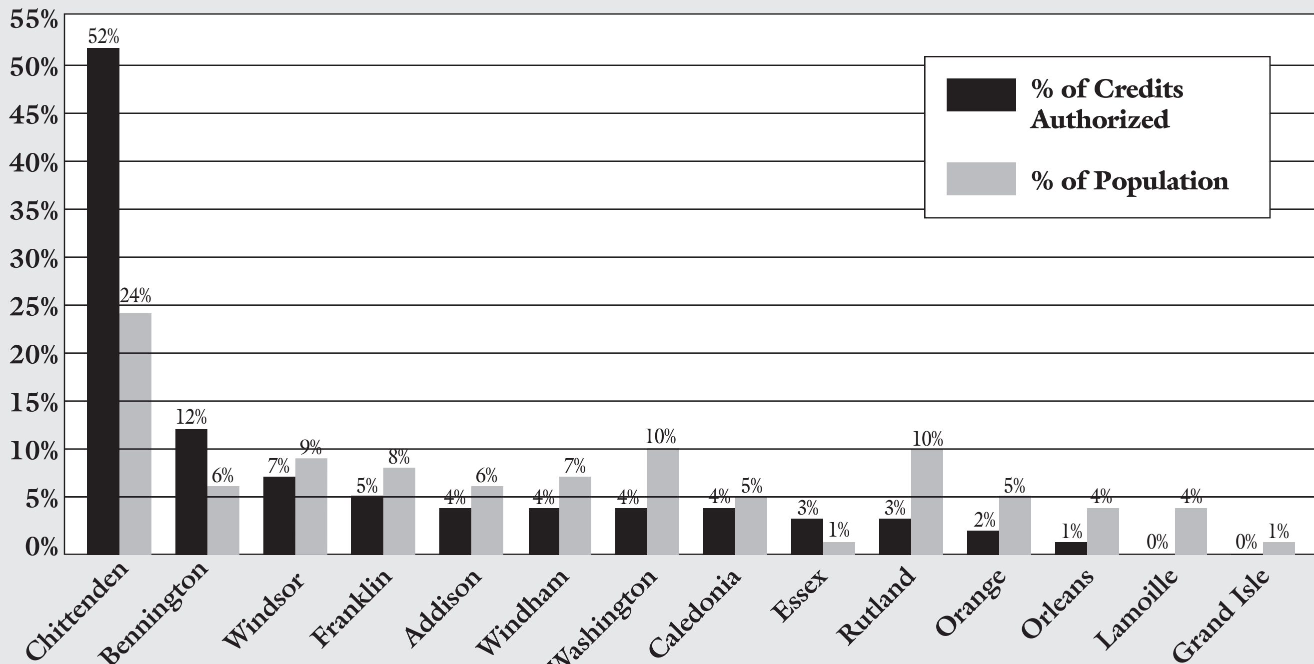
Companies should not be able to receive tax credits while failing to add required jobs, omitting essential performance information, or while reducing employment.

For example, the Tax Department allowed one company $835,000 in research and development credits for the 2001 tax year. The company applied approximately $43,000 to reduce State taxes for that tax year, and carried forward $792,000 to use against future tax liabilities. This claim was allowed during a tax year in which *the company reduced employment by more than 20 percent*.[8]

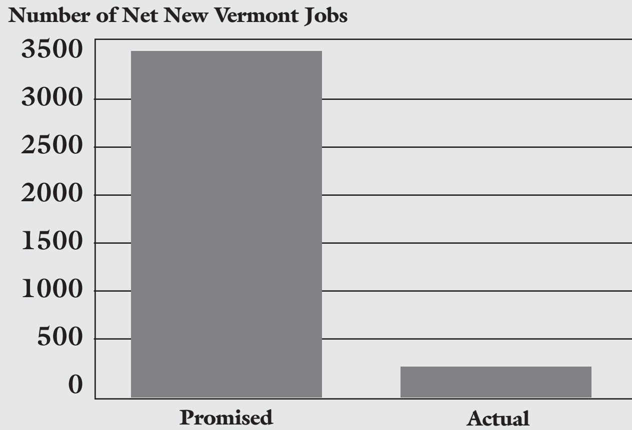
Tax credits are currently allowed by the Tax Department and VEPC in piecemeal fashion, contrary to 32 V.S.A. §5930a(l)(1)(B). In the above example, R&D investment credits were allowed without reference to critical employment performance information. ***This practice of piecemeal review divorces award approval from the economic benefits as measured by the cost-benefit model and results in significant additional State fiscal expense.***

In the example cited above, the Tax Department could have turned to VEPC for assistance.

32 V.S.A. §5930a(l)(1)(B) states: "If the Tax Department is unable to determine full compliance with the performance expectations, the department



PROMISES KEPT?
Promised vs. Actual Net New Job Creation by 21 Audited Companies



shall request that the council conduct a more detailed review." The program began in 1998, but as of June 30, 2004 the Tax Department had not sent any notices to VEPC requesting additional review of compliance. The first of these requests was sent in November of 2004.

RECAPTURE SLOW

The lack of controls in reviewing tax credit claims has resulted in significant State expenditures associated with EATI tax incentives without concomitant job and related economic growth. Based on our review, the direct cost to the State in potential foregone revenues for these 226 net new jobs is more than $92,000 per job.

The Tax Department has been slow in reclaiming or "recapturing" tax credits from non-performing businesses. 32 V.S.A. 5930a(m)(1) states, "The value of any economic incentives taken by an applicant that has obtained the council's approval under this section shall be refunded to the state, and any economic incentives remaining to be exercised shall be disallowed in the event that: (A) the applicant fails to comply with all performance expectations upon which the award was conditioned …"

Although many companies appear to have violated minimum job levels – some for more than 2 years – the first letters sent by the Tax Department to VEPC regarding possible recapture claims against 37 companies were issued in July of 2004.[9]

VEPC AWARDS CONTINUE TO BE INVERSELY RELATED TO UNEMPLOYMENT RATES

County	Share of VEPC Awards	Unemployment Rate (12/03 to 11/04)
Chittenden	51.7%	2.7%
Bennington	11.5%	5.2%
Windsor	7.0%	2.9%
Franklin	4.7%	4.2%
Addison	4.1%	3.3%
Windham	3.9%	3.0%
Washington	3.8%	3.8%
Caledonia	3.8%	4.8%
Essex	3.4%	4.8%
Rutland	2.9%	4.4%
Orange	1.8%	3.2%
Orleans	1.0%	6.0%
Lamoille	0.5%	5.0%
Grand Isle	0.0%	5.1%

The State can greatly improve the financial integrity of this program with adequate systems to verify that companies claiming credits have accomplished their goals, and with prompt recapture procedures for non-performing companies. The performance of the program to date, however, calls into question its fundamental mission and its ability to accomplish this mission as now organized.

RECOMMENDATION 1

The Tax Department and VEPC should enforce the performance verification provisions in the EATI statute in a rigorous and timely fashion prior to allowing tax credits. The Tax Department should assure that companies meet ALL critical performance expectations before tax credit claims are allowed.

The Tax Department should issue recapture notices and adjustments in a timely manner.

[9] The Economic Progress Council has rescinded awards in a number of clear situations, such as when a business closes, moves out of state, reports cancellation of the project, or files no tax credit claims and fails to file annual Activity Reports as required.

The Tax Department and VEPC should not allow tax credit claims in piecemeal fashion as is the current practice. Both agencies should assure that rules for partial award payout for partial performance are consistent with the economic benefits to the State as measured in the cost-benefit model.

The Tax Department and VEPC should insure that tax review compliance forms and procedures are consistent with critical cost-benefit model inputs underlying the awards, especially new employment payroll and business investments.

The Tax Department and VEPC should immediately disallow and recapture more than $8 million in EATI credits inappropriately allowed to eight companies that have reduced employment while claiming EATI tax credits.

The Legislature should place a moratorium on all new awards until the Tax Department and VEPC have put in place adequate controls to enforce key performance expectations for all awards as required by law.

The Legislature should also:

- **review and clarify any statutory issues of program administration and enforcement that Tax and VEPC have failed to accomplish; and**
- **review program cost-effectiveness and consider measures to simplify or restructure the program so as to insure that the statutory intent of creating quality jobs for Vermonters has been accomplished.**

Vermont: A Very Attractive Place For Business Success

Is Vermont unattractive for business growth? That's hardly the case, according to some analysts.

A recent "State Competitive Index" study indicates that Vermont is now ranked eighth in the country in terms of its ability "to be able both to attract and incubate new businesses, and to provide an environment that is conducive to the growth of existing firms." (The states ranked above Vermont for competitiveness are, in order: Massachusetts, Utah, Washington, Minnesota, Colorado, Nebraska and New Hampshire.)

The report, by the Beacon Hill Institute for Public Policy Research, a non-profit research organization, defines competitiveness as "the policies and conditions that ensure and sustain a higher level of per capita income and its continued growth."

Released on November 17, 2004, the study "assigns more than three dozen variables to eight categories: government and fiscal policy, security, infrastructure, human resources, technology, business incubation, openness, and environmental policy." These eight measures are combined to form a single "competitiveness" index.

In these categories, Vermont ranks as follows:

Category	Rank
Government and Fiscal Policy	27
Security	9
Infrastructure	39
Human Resources	3
Technology	4
Business Incubation	46
Openness	9
Environmental Policy	4

Vermont's best score is in the Human Resources area, defined in the report this way: "A high level of labor force participation, and skilled labor that is readily available and not too expensive, combined with a widespread commitment to education, training and health care, make a state or metropolitan area attractive for business."

The report notes that "the outcome of competitiveness is greater affluence, measured by higher levels of real Gross State Product or personal income per capita." Local and state policies are important, as all state and metro areas in the U.S. face pretty much the same macro-economic conditions. The report notes, "Wealth is actually created at the microeconomic level … in the ability of firms to create valuable goods and services using productive methods."

For the full report, see: http://www.beaconhill.org/Compete04/Compete2004WEbONLY.pdf.

FINDING 2

VEPC and the Tax Department have not developed specific performance expectation standards for companies which received tax credit awards prior to July 1, 2000 totaling more than $64 million. This is in spite of statutory guidance (§5930a(k)), and a commitment to do so from then-Tax Commissioner Richard Mallary in January of 2003.

Because the two agencies have failed to develop clear performance expectation documents for these awards, the Tax Department has allowed millions in tax credits without having verified whether companies created promised jobs, made promised investments or achieved other critical performance expectations.

This delay in developing performance expectation measures may cost the State significant sums that cannot be recaptured. We found many instances of companies that failed to meet their annual objectives but were still allowed substantial credits. The Tax Department now asserts that the 3-year statute of limitations outlined in 32 V.S.A. §5882, could prevent the Department from reclaiming millions in tax credits that were improperly allowed in the 1998, 1999 and 2000 tax years. This includes approximately $12.7 million of the $18.8 million in income tax credits allowed to the 21 companies we reviewed.

In addition, although VEPC and the Tax Department have made administrative improvements, they do not collect all essential company performance information, which has led to a program that is unwieldy, and difficult and time-consuming to administer.

DISCUSSION

Our February 4, 2003 report, "Promises to Keep," found that the Tax Department had allowed tax credit claims without fully verifying that companies had created the promised jobs and made the promised economic investments. We faulted the Tax Department for not having review procedures in place, for a lack of staff to address a serious backlog of un-reviewed claims, and in general for not holding companies accountable for the promises made in their applications.[10]

A PLEDGE TO ACT

In his response to the findings, then-Commissioner of Taxes Richard Mallary made a clear commitment almost two years ago for the Department to use its authority to assure that performance was achieved prior to allowing tax credits:

"The Department shall proceed from this point forward on the basis that the language in the award letters made all awards conditional and that the inherent powers of the Department allow it to reduce or deny credits awarded by VEPC."

Commissioner Mallary added:

"… The Department will endeavor to apply the procedures established in 32 V.S.A. §5930a(l)(1) with respect to credits awarded prior to July 1, 2000. The Department will:

"1. request VEPC to provide it with very detailed performance expectations for all credits awarded by VEPC prior to July 1, 2000. These performance expectations, or benchmarks, which would be similar to the performance expectations the Council now specifies for awards authorized after June 2000 pursuant to 32 V.S.A. §5930a(k), will be used by the Department to determine whether there is full or partial compliance with the expectations and to determine what portion, if any, of the approved credit should be allowed; and

"2. review future requests for the utilization of credits pursuant to these benchmarks and allow or deny credits on that basis."[11]

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[10] The Auditor's February 4, 2003 report suggested that the Department did have authority to review claims for job-creating and economic investment performance because early award letters from the State to a company typically stated, "As you know, in order to claim the credits, (company name) will have to actually perform and make the investments as noted in the application, if they have not done so already."

[11] Richard Mallary, then-Commissioner of Taxes, January 31, 2003.

Commissioner Mallary's determination made it clear that all the relevant branches of State government involved with the tax credits were finally "on the same page" regarding the need for the State to determine whether a tax credit recipient has complied with the performance expectations promised by the company before being allowed to claim a tax credit, no matter when the award was made.

Delays are costly

It took until June of 2004 – nearly 18 months – for the Department to send a letter to the Council requesting specific performance expectation documents.[12] This delay may prove costly. The EATI statute (§5930a(l)(2) and §5930h(c)(1)) provides for up to 6 years during which credits may be adjusted, reclaimed or recaptured. In spite of this clear guidance, the Tax Department claims that its general 3-year statute of limitations (32 V.S.A. §5881 and §5882) applies to EATI credits.[13] Under this interpretation, the statute of limitation would expire before the job creation period is even completed.

Here is an example of how delays and inadequate performance information may have cost the State:

The Tax Department conducted a comprehensive field audit of a company which was in the fifth and final year of its EATI authorization period. The firm, however, had not yet made any EATI tax credit claims. After the audit was completed but before it was officially closed, the company asked the State to amend the corporate work papers to account for past EATI credits it could have claimed, but did not.

The Tax Department agreed to this request and provided the company with the tax credit schedules to claim tax credits in three tax years. In June of 2003, the Tax Department reviewed the tax credit claims and allowed credits in two tax years totaling $428,700, which significantly reduced the company's tax liability. In September of 2003, the Tax Department sent a refund check to the company in the amount of $223,778 and closed the audit.

Critical to this discussion is the fact that the Department did not verify the company's job record in the two tax years for which the company claimed credits. The company's own reports show that in the first year, no new jobs were created, and that in the second year, employment was reduced by two jobs. Had specific performance expectation documents been in place, the State would have had a clear basis for disallowing all or part of the tax credit claim.

The Tax Department and VEPC should develop basic performance expectations for the above company based on the original VEPC letter of certification for the award including promised employment growth and other critical inputs from the cost-benefit model. The Tax Department should then re-review the tax credit claims in light of these performance expectations.

Authority to reclaim credits needs clarification

All EATI awards are based on economic projections made for a 7-year period. The EATI performance review process extends to 6 years. However, companies can claim the full value of an EATI award by meeting the first 5 years of projected economic growth. This 5- to 6-year time horizon for project performance and review is an essential part of the EATI program. This is why the authority to adjust, reclaim and/or recapture EATI credits is specified in the enabling statute for a period of 6 years, per sections §5930a(l)(2) and §5930h(c)(1).[14]

The Tax Department, however, believes that the EATI provisions for recapture are superseded by a 3-year statute of limitations detailed in 32 V.S.A. §§5881-

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[12] The Council, after several months, agreed to provide performance expectation documents for companies with the smallest employment growth, as requested by Thomas Pelham, Commissioner of Taxes, in an October 12, 2004 follow-up letter to Fred Kenney, Executive Director of the Vermont Economic Progress Council. As of this report date, the Council is waiting for a list of those initial companies to be produced by the Tax Department.

[13] Per e-mail correspondence from Dale Macomber, EATI review team leader, December 7, 2004, "The time limit on the notice of deficiency for a filed tax return, including a VEPC credit, is controlled by statutes §5881 and §5882. No other statutes extend that time limit."

[14] Even though the cost-benefit model assumes company performance as promised in the EATI application for a period of 7 years, awards are granted in full after only 5 years of performance as promised, with 1 additional year of review. See Finding 7 for more discussion.

§5882. Such an interpretation of statute would severely impact EATI program costs. In short, it eliminates the ability of the Tax Department to make necessary adjustments based on actual company performance over the period of time specified in all EATI applications and allowed by the authorizing statute.

The Legislature should confirm the Tax Department's authority to reclaim credits from non-performing companies for at least six years.

ISSUES WITH INFORMATION FLOW

The information flow among companies, VEPC and the Tax Department is problematic and affects how efficiently and effectively tax returns are reviewed. For example, in examining tax return files compiled by

Minnesota: Public Disclosure is Key

The State of Minnesota passed what is believed to be the nation's first economic development accountability statute in 1995 which covered most state incentives over $25,000 that are not generally available to all businesses or a class of similar businesses.

The law defines a business subsidy as "a state or local government agency grant, contribution of personal property, real property, infrastructure, the principal amount of a loan at rates below those commercially available to the recipient, any reduction or deferral of any tax or any fee, any guarantee of any payment under any loan, lease, or other obligation, or any preferential use of government facilities given to a business."

However, a number of subsidies are exempt from the statute, including state assistance for housing, energy conservation, pollution control or abatement, some Tax Incremental Financing (TIF) districts, certain loan programs, and other benefit categories.

The law requires companies receiving assistance to sign a subsidy agreement which must include key information, such as:

1. description of the subsidy, including the amount and type of subsidy;
2. a statement of why the subsidy is needed;
3. goals for the number of jobs created or retained;
4. wage goals for the jobs created or retained;
5. a description of the financial obligation of the recipient if the goals are not met;
6. a commitment to continue operations for at least 5 years;
7. and a list of all financial assistance for the project from all state and local sources.

The law requires extensive public reporting on subsidies, both from local granting agencies, and the statewide Department of Employment and Economic Development which receives reports from all granting agencies.

Annual reports are due March 1 for activities of the previous year, and must include:

1. the hourly wage of each job created;
2. the sum of the hourly wages and cost of health insurance provided by the employer;
3. an update on achievement of job-creation goals;
4. information on any parent corporation, and financial assistance for the project from all state or municipal sources.

At the statewide level, the Commissioner of the Department of Employment and Economic Development must produce a public compilation of local and state reports by August 1 of each year. The report must include, among other items:

1. the percent of all business subsidies that reached their goals;
2. the number of part-time and full-time jobs created, and benefit levels for each;
3. total dollar amount of subsidies that did not meet their goals; and
4. a list of recipients that have failed to meet the terms of a subsidy agreement in the past 5 years and have not satisfied their repayment obligations.

For more on the Minnesota Economic Development Subsidy Accountability law, see: www.goodjobsfirst.org/minnesota.htm, or Minnesota Statutes 1999 supplement, §116J.993 et seq.

the Tax Department, we noted that many files lacked completed company Activity Reports for each tax year. Some companies omitted the reports entirely. One firm, for example, left annual employment and wage sections blank because it believed – incorrectly – that if the company didn't claim a payroll tax credit in that year it did not need to report on jobs and wages. Though companies must, by statute, file an annual statement that they have not reduced employment below a threshold level, we found only one of the 21 companies examined had filed such a statement.[15] In addition, though one line on the specific capital investment tax credit schedule asks for the number of full-time Vermont employees, some firms would insert "less than 250" or "greater than 100" or similar language. This requires the tax examiner to do more research to ascertain the estimated employment levels at the company. The capital investment tax credit schedule could require more information from the taxpayer, such as detail on expenditures or a depreciation schedule, to help the Tax Department clarify the basis for the investment tax credit claim.

A CHALLENGING WORKLOAD

The Tax Department's workload has, and will continue to, increase due to the complexity of the statute and program operations, and the increasing number of companies and credit categories in the program. The Department has taken steps recently to meet this challenge. Earlier this year, the Tax Department improved its approach to reviewing more recent tax credit claims. The Department created a five-member team to review EATI tax credit claims, adopted procedures for regular review as well as field audits, improved schedules and record-keeping and has recently begun the process of recapturing tax credits it allowed in the past from companies that may have cut too many jobs.

We note that VEPC has recently improved some of its procedures as well. For example, the Council has adopted procedures to deal with re-assignment of tax credits when awardees are involved in various types of stock sales, asset purchases, reorganizations or when they acquire new entities in Vermont.

VEPC's workload is growing, too. For example, the Council's two-person staff recently began implementing for the first time two important functions outlined in the statute. One relates to the duties of the Council to review company information in a possible recapture action or performance review initiated by the Tax Department. The other relates to procedures involved when a company that has experienced layoffs submits a request to defer any recapture of credits one year in order for the company to rebuild its employment levels. The duties related to these functions could adversely impact the staff's ability to administer the program in a timely and effective manner.

RECOMMENDATION 2

The Tax Department should obtain all critical information needed to evaluate company performance from the applicants and/or VEPC in a timely fashion, before awards are allowed. This includes annual employment data, a clear attestation of minimal employment levels during the year, and all other information required to evaluate all performance expectations upon which the award was conditioned. This must include all critical inputs used in the cost-benefit model to establish the award level.

Within 60 days, VEPC should provide the Tax Department with performance expectation measures for all companies that received awards prior to July 1, 2000. These performance expectation goals should be consistent with the cost-benefit model inputs upon which the awards are based and the specific conditions outlined in the original letters sent to the applicants announcing their award approval by VEPC.

The Tax Department and VEPC should begin immediate action to recapture, in the most direct way possible, credits earned, applied or carried forward by companies with significant job losses that have clearly failed to meet performance goals.

The Legislature should confirm the Tax Department's authority to reclaim credits from non-performing companies for at least six years.

The Tax Department should revise the employment certification language on Form 5930H.

[15] We found the language in the Form 5930H requesting this information to be potentially confusing and suggest that the Tax Department reword it and include it more prominently in forms to be filed by all companies who have claimed EATI awards.

FINDING 3

There is no program expenditure cap or meaningful limitation on VEPC authority to grant tax credits which reduce future State revenues. These substantial off-budget tax expenditures constitute a large and growing contingent liability to the State not specifically approved by the Vermont Legislature during the budget process and not accounted for in the State's financial statements or budget.

In any given year, this liability could result in revenue reductions of $10 million or more.

DISCUSSION

The tax credit program remains a financial risk to the State for several important reasons. First is the large amount of money committed without annual Legislative review, debate, decision, or approval by the Governor:

$104 million in tax credits authorized;
$29.5 million in income tax credits allowed;
$2.1 million in municipal awards utilized;[16]
$13.6 million applied against income taxes;
$15.9 million carried forward.[17]

Tax expenditures represent a growing form of government spending with little or no oversight and mounting financial risks, notes Michael P. Ettlinger, Tax Policy Director of the Institute on Taxation and Economic Policy. He writes:

"Tax expenditures are, for the most part, subsidies. In general, subsidies are a form of government spending that requires close scrutiny and constant review. The transfer of government funds to private parties is not to be taken lightly. For most subsidies accomplished through tax expenditures, however, oversight is at a minimum. First of all, they are entitlements. Thus, they are not subject to review with each budget cycle.

"Also, unlike most spending, tax expenditures are rarely paid for by an explicit tax increase or prioritized with respect to other spending. They are largely left out of the painful budget process whereby the hard choices between spending on education, roads, prisons and other competing public needs are made …

"Furthermore, tax expenditures are often impregnable to attack for not achieving their purpose. An economic development agency subsidy program that granted direct payment of millions

Boosting Businesses: Let Us Count the Ways

Tax incentives are just one of many ways that Vermont is helping businesses thrive. Trouble is, legislators never get a complete view of all those efforts, which would help them balance the needs of business with other state budget priorities.

A first step out of this budget bind would be getting a handle on the annual costs and benefits of all the various state programs that have job creation and economic growth as a goal.

A new tool for this task is gaining acceptance in public budgeting. It's called a "Unified Development Budget," and it can give leaders a much better picture of what the state is spending on economic development and how to make the expenditures open for all to see, and accountable.

A Unified Development Budget brings all the economic development spending together – on budget, and off budget – in one place. Vermont's Unified Development Budget would include costs for tax incentives, business subsidies, workforce training and apprenticeship programs, economic development initiatives and administration, tourism promotion, and many one-time expenditures to create jobs.

Such a budget would foster debate about goals and priorities, about costs and benefits, and about the actual results of certain government expenditures. It helps to create an open, informed debate about both budget and off-budget spending strategies because all government expenditures are on the table, open for inspection and the informed debate that Vermonters prize.

of dollars to large corporations would be carefully scrutinized. The agency would monitor the program to ensure it accomplished its objectives. During the budget process the legislature would demand, and the agency would provide, data proving the program's effectiveness.

"But call this same program an 'Investment Tax Credit' or 'Research and Development Credit' and such scrutiny is much less likely … Frequently, no one is accountable for tax expenditures. In fact, tax expenditures are often, in effect, given the highest priority of any spending programs. They are in the privileged position of being an entitlement, reviewed infrequently and rarely is an agency held accountable for their effectiveness …

"The bottom line is that for every dollar in revenue lost through tax expenditures, someone else has to pay a dollar more in tax, or lose a dollar in other spending."[18]

The national Government Finance Officers Association (GFOA) suggests that clear, comprehensive budget documents are essential to good government. The GFOA notes, "Significant changes to major revenue sources – projected and actual – should be highlighted in the budget document…" as "even a relatively small variance in a major revenue source can have a significant impact." [19]

Our previous report suggested bringing tax expenditures out in the open for Legislative discussion:

"As more and more state governments offer ever increasing tax incentives and other subsidies to lure businesses to their state, it may be that reduced state corporate tax revenues as a result of these subsidies are now a 'fact of life.' If so, this fiscal reality should be understood as a real cost that must be paid for by

Oregon Legislature Requires Tax Expenditure Report

In 1995 the Oregon Legislature amended its "Budget Accountability Act" to require the state's Administration to prepare a biennial report of tax expenditures "that will allow the public and policy makers to identify and analyze tax expenditures and to periodically make criteria-based decisions on whether the expenditures should be continued."

The Legislature found that the report will allow "tax expenditures to be debated in conjunction with on-line budgets and will result in the elimination of inefficient and inappropriate tax expenditures, resulting in greater accountability by state government and a lowering of the tax burden on all taxpayers."

The Budget Accountability Act defined a tax expenditure as "any law of the Federal Government or this state that exempts, in whole or in part, certain persons, income, goods, services or property from the impact of established taxes, including but not limited to tax deductions, tax exclusions, tax subtractions, tax exemptions, tax deferrals, preferential tax rates and tax credits."

The law requires the state administration to include in the report:

- a list of each tax expenditure;
- the statutory authority for each tax expenditure;
- the purpose of each tax expenditure;
- an estimate of the amount of revenue loss caused by each tax expenditure for the coming biennium;
- the actual amount of revenue loss in the preceding biennium for each tax expenditure; and
- a determination whether or not each tax expenditure "has successfully achieved the purpose for which the tax expenditure was enacted and currently serves, including an analysis of the persons that are benefited by the expenditure."

Oregon's report describes about 350 individual tax expenditures specified in state law, approximately 115 related to local property taxes, 200 related to the personal and corporate income taxes, and the remaining related to other state tax programs.

To view the State of Oregon 2001-03 Tax Expenditure Report, see: http://www.dor.state.or.us/statistical/ExpR0103/TOCexp.html

Authorizations by Year

Year	Amount
1998	$36,589,304
1999	$31,858,500
2000	$14,806,309
2001	$4,992,134
2002	$10,606,763
2003	$15,483,462
2004 (as of Oct.)	$17,890,129

Total Incentives available as of June 30, 2004 (FY 04) less inactive incentives: $104,187,117

Source: Nov. 4, 2004 VEPC Master List Report.

raising other taxes or reducing State expenditures to compensate for this revenue loss." [20]

A second key risk factor is that the tax credits (and tax expenditures) do not have an annual cap. In the past seven years, annual awards have ranged from a low of approximately $5 million to a high of over $36 million. Consulting economist Thomas Kavet suggests that because, in his view, economic development is more closely linked with the business cycle and market demand (and not the availability of credits), applications for tax incentives will tend to be fewer in an economic downturn (because demand is lowered and investment risk heightened) and much higher as the economy experiences an upturn and companies prepare to meet new demand. In other words, when times are better, and companies want to grow, they will apply for tax credits. This suggests that tax credits are not the best method for assisting companies in an economic downturn since demand for the credits in "hard times" is slack.

An annual legislative cap would serve three immediate purposes.

1. It would provide the Legislature with a yearly opportunity to review the costs, benefits and effectiveness of the program along with possible alternative spending for purposes of economic development;

2. It would reduce the likelihood of excessive authorizations during "good times" when many manufacturing companies experience cyclical periods of higher demand; and

3. It would encourage the Economic Progress Council to do a better job determining that companies are truly in need of financial assistance from the State by recognizing that State resources are not unlimited.

In our previous report, this Office stated, "The lack of a program cap, coupled with the lack of performance review by the Tax Department (relating to more than $60 million in awards before July 1, 2000) is a serious weakness in the state's system of internal controls and represents a significant adverse risk to the State … "[21]

The statement is accurate for the present as well. Companies which received awards before July 1, 2000, representing over $60 million in tax credit authorizations, have not received close scrutiny on performance by the Tax Department. Many have received tax credits while failing to add jobs or meet basic performance goals.

Adding to the risk is the fact that the Economic Progress Council analyzes only superficially the "but for" question which assesses the likelihood that a project would not proceed without an incentive. We believe the "but for" question as presently applied by the Council is an unreliable method for limiting risk and that even with greater Council scrutiny could not reliably limit State expenditure risk (see Finding 4). It is not an effective institutional mechanism for weeding out economic development proposals that would probably occur without State subsidies, nor can it be relied upon to insure that there is no net fiscal cost to the EATI program.

[16] This is only a portion of the municipal awards utilized, due to limited verifiable information at the time of review.

[17] Tax Department master EATI spreadsheet, June 30, 2004; property tax exemption figure from Property Valuation and Review division.

[18] Michael P. Ettlinger, testimony before the Minnesota Corporate Subsidy Reform Commission, May 11, 1998. www.ctj.org/html/mntest.htm.

[19] "Best Practices in Public Budgeting," Practice 9.2a, Government Finance Officers Association, 2000. www.gfoa.org/services/nacslb/Practices/9_2a.htm.

[20] "Promises to Keep," State Auditor's Office, February 4, 2003, page 43.

[21] Ibid.

RECOMMENDATION 3

The Legislature should annually authorize an award cap for the tax incentives program as part of its evaluation of economic and budget factors.

The Department of Finance and Management's *Comprehensive Annual Financial Report* **(CAFR) should include a report on outstanding awards and carry-forward amounts from this program in its footnote on contingent and limited liabilities.**

The Legislature should ask the Administration to prepare a Unified Development Budget which includes all expenditures that would encourage economic development.

The Legislature should require by law the inclusion of a tax expenditure report in the Governor's proposed budget each year.

FINDING 4

The "but for" test, upon which all claims of fiscal benefit to the State are premised, cannot be verified. Because the "but for" test assumes that all project benefits would not occur without the tax incentive award, true program costs are understated, while benefits are overstated.

VEPC does not provide adequate scrutiny in assessing "but for" statements of company officials applying for tax credits, thereby exposing the state to millions of dollars in unnecessary awards.

DISCUSSION

The determination of whether or not an applicant's intended investment would proceed in the absence of a State subsidy is called the "but for" test. All measurements of the State's return on investment and related fiscal benefits associated with EATI tax expenditures rely upon the assumption that "but for" the incentive, the investment would not occur in whole or in part.

VEPC bases the theoretical positive or negative return to the State for each project on the cost-benefit model; however, the model assumes the "but for" test to be true in each and every model run. Therefore, the "but for" test is critical in determining fiscal benefits because any State expenditure to "incent" an investment that would occur **without** the incentive would be an unnecessary expenditure.

It is not necessary to make a public expenditure for something that would occur without a public expenditure.

The "but for" test is administered by the Council and is entirely validated by the subjective judgment of the Council. The law states:

The Council shall first review each application under subsection (b) of this section and ascertain, to the best of its judgment, that but for the economic incentive to be offered, the proposed economic development would not occur or would occur in a significantly different and significantly less desirable manner.[22]

Despite the efforts of the Economic Progress Council, however, it is impossible to know with certainty whether a proposed investment would have occurred in the absence of a State subsidy.

This critical test, upon which the entire fiscal claims of the program are based, is subjective, with no quantifiable standards, and essentially without falsification risk to the applicant, unless via self-incrimination.

"BUT FOR" COACHING

While the "but for" question is prominent in the statute, we note that some companies seem to view it as a bureaucratic formality to satisfy the statute and pass muster with the Council.

In reviewing seven application files, we observed two distinctive "but for" letters from two different applicants in two different years that were largely identical. About the only difference in the two letters was the company letterhead. This indicates both institutional "coaching" in explaining this critical piece of company information and a disregard for the intent and import of this provision.

[22] 32 V.S.A. §5930a(c).

CORPORATE PRESSURE

In addition to reviewing application files we observed a number of closed, executive sessions where the Council discusses "but for" assertions, and may question applicants in person or by speakerphone.

In practice, the Council must assess the likelihood that applicants, as they sometimes clearly hint, would indeed move their company out of state, shift production elsewhere, close their business or scale back a project significantly, if they don't receive a tax incentive award.

Richard Cowart, former Chairman of Vermont Public Service Board, touched on this issue of corporate demands last year in comments to the Senate Committee on Finance about Economic Development Agreements that lower electricity rates for businesses in special circumstances, declaring:

> ***"It's also important to understand that pretty much anybody can say, 'Gee, my electric bill***

EXCERPTS FROM "BUT FOR" LETTER FROM COMPANY A

" ██ is a company at the crossroads of opportunity."

" ██ is assessing the economic assistance available from the governments in each of our global campuses for siting capital project investments and hiring new employees."

"In order to make these investments and create 100 new high wage jobs, ██ needs Vermont's assistance to grow our operations and create these significant economic and employment opportunities in Vermont."

"The Vermont Economic Advancement Tax Incentives program will provide us the vital economic incentives that will help enable us to select Vermont as the site for this significant opportunity and help us to generate high-paying jobs and economic benefits to our region and state."

"This expansion opportunity is conditioned upon the timely receipt of permits and economic incentives."

"BUT FOR these incentives ██ would not be making these significant investments in its Vermont campus."

"Thank you for your consideration of our application and your assistance in helping us to grow our business and create high wage economic opportunities in the state of Vermont."

EXCERPTS FROM "BUT FOR" LETTER FROM COMPANY B A YEAR LATER

" ██ is a company at the crossroads of new and exciting challenge and significant opportunity."

" ██ is assessing the economic assistance available from the governments in each of our global locations for siting capital project investments and hiring new employees."

"In order to make these investments and create 534 new high wage jobs, ██ needs Vermont's assistance to grow our operations and create these significant economic and employment opportunities in Vermont."

"The Vermont Economic Advancement Tax Incentives program will provide us the vital economic incentives that will help enable us to select Vermont as the site for this significant opportunity and help us to generate high-paying jobs and economic benefits to our region and state."

"This expansion opportunity is conditioned upon the timely receipt of permits and economic incentives."

"BUT FOR these incentives ██ would not be making these significant investments in our Vermont campus."

"Thank you for your consideration of our application, and your assistance in helping us to grow our business and create high wage economic opportunities in the state of Vermont."

is too high, and I'd like a discount, and if you don't give it to me perhaps I'll move, or expand somewhere else, or change my way of doing business.'

"Threats are cheap. And what you do if you create an environment where load retention rates are common is that you create a business environment where rewards are given out to those who threaten to leave. And … those who make the threats are cross-subsidized by those who don't make them. It just creates a world in which it becomes very difficult for the decision-makers to decide who should receive this preferential rate and who should not."[23]

FINANCIAL NEED NOT QUESTIONED

We note that companies, in their appearances before the Council and in their official "but for" letters, may assert that the tax credits are an essential financial component in making the proposed project a reality. These companies face little scrutiny of historical financial records. The key numbers in the application are related to projected new jobs and projected investment totals in the various tax credit categories on a year-by-year basis. The Council does not require companies to submit confidential historical financial information such as audited financial statements, business plans, or tax returns. Companies may claim that the incentives are vital "to make the numbers work," but the Council has little data to assess this claim.

Several of 21 companies we reviewed were Subchapter S corporations with individual owners or couples reporting personal incomes over $1 million per year from W-2 and K-1 statements. An S corporation passes the tax credits through to owners and shareholders, along with income and losses from the company. Up until July 1, 2003, these owners were able to apply tax credits against their Vermont State personal income tax liability, stemming from any source. (Now the tax credits must be applied against "income tax attributable to the allocated income from the business eligible for the credit."[24]) This financial background information – a sort of "credit check" – could have helped the Council assess potential equity available for financing an expansion and the need for supplemental assistance from the State.

The Vermont Economic Development Authority (VEDA), which administers several large loan programs targeted to Vermont businesses, typically requires income tax returns, financial statements, and other historical financial information from existing companies seeking major loans[25]. It should be noted, however, that VEDA requires this information to help provide assurance that the company will likely be able to make the required loan payments.

Without requiring historical financial information from applicants, it's hard to support the notion that the tax credits awarded are a true incentive (something that gives life to a project that otherwise would not make economic sense). Another view might be that tax credit incentives provide a potential future bonus (in addition to the profit and equity growth that could be realized) for taking financial risks and investing within the State.

As currently structured, the program certainly is a benefit to select Vermont companies and their owners. But it is not correct to say that the program is providing assistance to companies that need financial subsidies to make a project happen.

PROCESS FAVORS APPLICANTS

The "but for" question is critical and it is decided in an atmosphere that strongly favors the applicants, in our view, for these primary reasons:

1. The "but for" question is settled in closed session, typically with little or no presentation of counter-arguments, judging from sessions attended. For example, we observed one executive session where two company managers were questioned about possible options to expand production, and fill a considerable number of entry-level manufacturing jobs, in another state instead of its Vermont location. During the question and answer period, the Vermont managers stated they would like to

[23] Testimony to Senate Committee on Finance, November 10, 2003.

[24] 32 V.S.A. §5930i. We asked the Tax Department if it had an estimate of the amou2nt of EATI tax credits applied before July 1, 2003 against personal income tax liability not generated by the eligible business. Officials did not have a report on this amount, but indicated that it was likely substantial. Discussion, November 9, 2004.

[25] Discussion with Steven Greenfield, Deputy Manager, VEDA, November 18, 2004.

stay in Vermont where they had lived for over 15 years; that new Vermont workers hired would be paid $3 to $5 less per hour to start than in the other state and would receive Vermont state training subsidies; and that the company owned the Vermont location but would have to renegotiate a leased facility in the other state and pay for leasehold improvements should it move. Though it appeared from the managers' own remarks that the company would make a poor economic decision by moving new production to the leased facility out of state, no Council member raised this issue in the closed discussion period after the applicants left the room. Perhaps an argument to deny the tax credits would have been seen as an "anti-business gesture." Perhaps because the expansion was in a part of the State with few manufacturing firms, the Council decided to overlook any doubts about the "but for." The tax incentive request was approved in full.

2. The "but for" question is also decided in the context of a "frame of reference" bias. Tapped for their business experience or advocacy of business interests, housed in an agency dedicated to economic development and increasing jobs and investment in the State, and also engaged as a Council in long-range economic planning for the State, the Board's frame of reference becomes one of assisting each applicant business to reach its goals, rather than, as the statute implies, a body of impartial experts awarding the most deserving applications access to a limited amount of State support[26]. Indeed, in interviews with several Council members, it was stated that "trust" is an essential factor in the "but for" decision – the statement in person from an applicant that the tax credits are vital to a project is highly valued. All nine voting members are business professionals, some with past experience promoting projects in regional economic development corporations. Others are prior EATI award recipients. Like virtually all applicants, board members have a record of business ownership and management, financial risk-taking, and are sensitive to the perceived "business climate" of the State. There are no members on the Council explicitly representing the State Treasury, tax administration, taxpayer groups or labor to offer different viewpoints.

3. The Council does not analyze how the company might proceed without the incentives. There is typically no information requested of company executives about possible changes in the scale of the project, the number of new employees anticipated, the timing of the development, or the extent of new equipment to be purchased, etc., should the proposal not receive future tax credits. One Council member said asking an applicant to create alternative investment strategies should incentives be denied represents an inappropriate request of an entrepreneur typically working hard to surmount a number of barriers to development, such as permitting, financing, and other planning tasks.

4. The members are often bolstered in their "but for" decisions by hearing first that the cost-benefit model predicts a positive fiscal benefit to the State from the proposed development. A Council member could be forgiven for asking, "Why should we reject a weak 'but for' argument when the project is going to be fiscally net positive for the State anyway?" It is unclear how well the Council appreciates that the fiscal benefits to the State are positive only if the Council determines the project would not happen without incentives. In other words, the cost-benefit model is predicated on the fact that the incentives are necessary for the project to proceed, and that all benefits of a development are the result of the incentive being offered. If a company fails the "but for" test, any cost-benefit model run would indicate a net negative fiscal impact – in other words, the State would lose money if it subsidized something that was likely to happen anyway.

The "but for" test puts business leaders in a strange position, too; they must declare to the Council that without a relatively small amount of tax credits (proportional to the rest of the proposed project) which are usually applied well after the investments

[26] 32 V.S.A. §5930a(d) says, "In reviewing the application of a business or municipality under subdivision (c)(3) of this section to determine whether the applicant is eligible for the economic incentives under subsection (b) of this section, the council shall apply a cost-benefit model to determine the return on investment to the state, *relative to other applicants,* and to assist in establishing appropriate award levels for individual applicants …" (emphasis added.) This suggests that the Legislature envisioned competition between companies requesting State financial assistance.

are made (and only then if the company reports a taxable profit), they would not be making a substantial investment requiring funds many times greater than the amount of the tax credits. It's understandable that some business leaders are uncomfortable delivering such an attestation to the State.

We observed one executive session where business representatives were put in the position of having to state that not getting approval for a 10-year municipal award – averaging approximately $15,000 per year for 10 years – would jeopardize a $4.2 million construction project on land the company had already acquired. Though one Council member hinted that denial of the incentive would not make the proposed investment a financially imprudent one, the incentive was nevertheless approved.

One company executive framed the "but for" decision and the incentive award this way in one of the firm's annual Activity Reports to VEPC:

> ***"It was very difficult to attribute business decisions to a factor (incentives) that amounts to 10% of the benefits of that decision. Thus, to say we hired people, or (are) expanding because of the incentives, is stretching the logic. We hire people or expand because we need to, because we are growing. The incentives make it less painful."*** [27]

Increasingly, academic literature minimizes the role of state tax incentives in company investment decisions.[28] Research shows that businesses poised to make a large investment usually place much greater weight on such critical issues as basic market demand, transportation systems, workforce quality, cost and availability, facility options and many other central factors affecting the cost and return on an investment, than on possible state subsidies.

Vermont business leaders, for example, rated tax incentives as the 12th most important factor (out of 28 listed) in locating a facility in a 1998 survey. Quality of life ranked first.[29]

In some cases, a State subsidy could tilt the balance and critically affect a decision, but it is not usually the only or even the primary factor.

In Vermont, there have been well-publicized statements by Vermont firms receiving credits as to the true influence these credits had on their investment decisions. Only the threat of award rescission prompted later retraction of these public statements.

For example, after receiving an award and attesting to a "very real, very urgent 'but for' argument," one company cited in a *Wall Street Journal* article was quoted as saying that workforce quality and labor availability were more important in their Vermont business investment decision than was the tax credit incentive.[30] The article noted that "only two of the 21 companies contacted by The *Wall Street Journal* say [EATI] credits were the deciding factor in moving ahead with expansion in Vermont."

This illustrates the difficulty in verifying the "but for" test and other application information based solely on a company's representations. With a great deal of money at stake and no verification possible, this test should not be the basis of net fiscal calculations by the program.

To attribute the entire stream of future economic benefits from an investment to this single factor is not accurate. Yet this is precisely the assumption behind the cost-benefit model and the assertion that there is a positive return on investment – and no net fiscal cost to the State – from this program.

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[27] Confidential Activity Report of a company for 2001.

[28] See, for example, "Tax Incentives and the Disappearing State Corporate Income Tax," by Dr. Peter Fisher, State Tax Notes, March 4, 2002, Vol. 2 , No. 9.

[29] "Electricity Prices and Competitiveness Issues for Vermont," Appendix H of "Vermont Electricity Prices: Regional Competitiveness Outlook," Central Vermont Public Service Corporation, November 17, 1998, page 4.

[30] Jeffrey Krasner, "Did Vermont's Tax Credits Really Sway Firms?", *The Wall Street Journal*, September 20, 2000.

RECOMMENDATION 4

The Legislature should eliminate the "but for" test as the basis for fiscal cost measurement in the EATI program. It cannot be relied upon as the basis for asserting that there is a positive return on investment, and thus no net fiscal cost to the State from this program. Maximum potential returns and benefits may be reported as such, but program expenditures should be accounted for at face value and governed by legislative budget authorization.

The Legislature should enhance the diversity of the Council to promote critical review of projects and maximize program return on investment by designating two or more voting positions on the Council to individuals representing the interests of the State Treasury with experience and knowledge of state revenue and tax issues.

The Legislature should also consider including voting representation of other important economic development interests, such as labor, on the Council.

If the "but for" test is retained, the Council should require relevant historical company financial information to help scrutinize attestations.

FINDING 5

The Tax Department and VEPC lack effective procedures to review and adjust EATI municipal awards when a company does not perform as promised.

To date, 17 towns have received awards totaling $11.5 million for municipal awards conditioned upon the promised economic performance of 17 companies.

Four of these 17 companies were included in our current review of 21 companies. The municipal awards linked to these four companies comprised more than 70% of the total municipal awards granted by VEPC. We found that three of the four companies failed to add the promised number of new jobs. Neither VEPC nor the Tax Department made adjustments to any of the affected municipal awards when companies clearly missed performance goals for new jobs or investments.

The agencies' failure to make these adjustments means that the State's Education Fund may have forgone significant revenues which must be paid by other taxpayers.

Costs associated with municipal awards for tax increment financing (TIF) districts cannot be adequately measured by the cost-benefit model and expose the State to unnecessary financial risk.

DISCUSSION

There have been more than $11 million in EATI awards granted to municipalities between September, 1998 and June 30, 2004 (see below table) for property tax incentives available to applicants.

AWARDS ARE CONDITIONED UPON PERFORMANCE

Every municipal award is linked to a VEPC application from a private sector company and is analyzed in tandem with the company's application. The cost-benefit model considers the cost of the

municipal awards when calculating net fiscal benefits and calibrates these benefits based on the expected fiscal return from the private sector investments to be made.

If the private sector firm does not make the promised investments or make promised hires, the municipal award should be adjusted accordingly. However, currently, there have been no performance reviews or award adjustments by either the Tax Department or VEPC with respect to municipal awards. In order for the program to be "performance-based," such follow-up is essential.

This follow-up could originate with either VEPC or the Tax Department. However, the division handling these awards would not be the corporate income tax section, which handles all other EATI award review, but the Property Valuation and Review section, which handles issues related to the appraisal and taxation of properties for the Statewide education property tax. Clearly, these two divisions and VEPC must communicate about any performance shortfalls with EATI awards.

The VEPC Executive Director suggested corrective procedures be implemented when this issue was raised during the last audit. Although procedures were designed and implemented for new applicants, no follow-up procedure has yet been implemented for awards previously issued. These awards, like all EATI awards, are clearly conditioned upon the economic performance of a company.

MUNICIPAL AWARDS THROUGH JUNE 2004

Municipality	Linked Company	Award	County	Date
Town of Castleton	Hubbardton Forge	$47,400	Rutland	Oct-98
City of South Burlington	IDX	($2,693,000)*	Chittenden	Nov-98
Town of Milton	Husky	$6,808,500	Chittenden	Nov-98
Town of Randolph	Clifford of VT/NE Precision	$25,600	Orange	Nov-98
Town of Cavendish	Black River Produce	$120,000	Windsor	Jan-99
Town of Bennington	Abacus	$77,963	Bennington	Feb-99
Town of Bennington	Bennington Iron Works	$15,657	Bennington	Aug-99
Town of St. Johnsbury	Lydall Westex	$301,490	Caledonia	Aug-99
Town of Randolph	Vermont Pure	$101,289	Orange	Sep-99
City of Montpelier	Connor Construction/Cabot	$43,700	Washington	Apr-00
City of Newport	N. Pediatrics & Adol. Med.	$15,158	Orleans	Apr-00
Town of Hartford	Allan's Vending	$14,906	Windsor	Aug-00
Town of Hartford	Hanover Capital Mgt.	$91,700	Windsor	Sep-00
City of Burlington	Gilbane	$1,551,709	Chittenden	Apr-01
Town of Bennington	Global Z	$19,520	Bennington	Apr-01
Town of Randolph	Dubois & King	($108,700)**	Orange	May-02
Town of Waterbury	Green Mtn Coffee	$200,127	Washington	Sep-02
Town of Waitsfield	Northern Power Sys.	$151,900	Washington	Sep-02
Town of Berlin	Connor Group	$139,708	Washington	May-03
City of Montpelier	Cabot Creamery	$259,760	Washington	Nov-03
Town of Randolph	Dubois & King	$190,203	Orange	Jan-04
City of South Burlington	IDX	$1,126,100	Chittenden	Mar-04
City of St. Johnsbury	Lydall Thermal/Acoustical	$140,000	Caledonia	Apr-04
Town of Randolph	Micropack	$101,300	Orange	June-04
		TOTAL: $11,543,690		

** rescinded Mar-04 and replaced with new authorization*

*** (amended with new amount set Jan-04)*

VEPC's current procedure for municipal award follow-up lodges performance review with VEPC, not the Tax Department. If VEPC is to effectively perform this function (and it is not clear it should since the Tax Commissioner has final say on award adjustments) it must have access to company tax returns and other data used by the Tax Department to determine performance compliance. Given this additional administrative burden, it might be preferable to have the income tax division of the Tax Department communicate any performance adjustment directly to the Property Valuation & Review division of Tax and the affected municipality.

All municipalities that have received EATI municipal awards should be clearly informed of the performance-based nature of the program. They should understand the procedures for adjustment if the linked company does not perform as promised. There should also be an annual schedule for claiming municipal awards that is consistent with annual company claims and performance, and clear communication between VEPC and the Property Valuation and Review division at the Tax Department regarding these awards.

The information reported to the Legislature in the annual report mandated by 32 V.S.A. §5930a(j) does not now include adequate data on State revenue foregone as a result of EATI municipal awards.

The costs associated with one type of municipal award, for the creation of a tax increment financing (TIF) district, cannot be adequately measured by the cost-benefit model and thus should be discontinued. This is because such an award allows a municipal award, not solely for a specific company's development, but to include an entire geographic region as defined by the TIF district. There is no limit to the potential foregone state education property tax revenue from such a district. Linked municipal awards should be specific to incremental property value associated with the applicant's proposed development.

RECOMMENDATION 5

The Tax Department and VEPC should develop and implement procedures to track linked municipal awards and cancel, recapture or adjust municipal awards when a company linked to a municipal award does not meet performance expectations.

VEPC and the Tax Department should include accurate data in the annual EATI report to the Legislature on State revenue that has been foregone as a result of EATI municipal awards.

The Legislature should discontinue EATI municipal awards for tax increment financing districts.

FINDING 6

Current award review processes allow tax credit claims for research and development (R&D) investments, as well as some other tax credits, even when company expenditures fall below typical annual expenditures in years *before* the tax credits were awarded.

DISCUSSION

The EATI program is generally based on incenting incremental economic activity. It attempts to reward economic growth, not stagnation or decline.

One exception to this principle is the EATI research and development tax credit. This credit may be applied to any level of company R&D spending, regardless of whether it is above, at, or below prior-year expenditures. The program as administered allows firms that reduce their R&D spending to qualify for EATI rewards.

The R&D credit also is not subject to specific cost-benefit model estimation of fiscal neutrality. It is allocated based on arbitrary factors that often do not result in net fiscal gain to the State when evaluated in isolation from other EATI performance expectations. R&D credits should not be allowed unless other critical performance expectations, such as payroll or capital investments, are achieved.

EATI capital investment and other credits may also be granted for levels of activity that do not represent incremental growth. Investment patterns in prior years should be evaluated prior to award approval so as to insure that capital investment tax credits apply

only to specified incremental growth. Unlike R&D and most other credits, net fiscal benefits for capital investments are explicitly calculated by the cost-benefit model, and, assuming perfect judgment of the "but-for" test by VEPC, can be considered fiscally neutral.

RECOMMENDATION 6

Option 1: **The Legislature should discontinue the R&D credit and focus the EATI program on new jobs and investment and ensure that the program is truly performance-based.**

Option 2: **The Tax Department and VEPC should revise procedures to clarify that research and development, as well as capital investment and other credits, are to be based on annual incremental expenditures only, not on all annual expenditures. Allowance of an R&D award must be conditioned upon achievement of other critical cost-benefit model inputs such as payroll growth and/or new investment.**

The cost-benefit model should be revised to explicitly estimate net economic and fiscal impacts from incremental R&D and other expenditures and allocate award levels accordingly.

FINDING 7

Applicants who apply for a second EATI may be receiving awards based on performance promises for past years. This could result in redundant awards to "re-incent" the same economic activity and additional fiscal expense to the State.

Current economic conditions could create substantial future revenue exposure to the State if companies are "incented" for normal cyclical recovery from the recession in future years.

DISCUSSION

The current cost-benefit model sets award levels based on seven years of promised economic activity, which is usually defined by permanent job growth, or investment levels. Yet under current procedures, awards can be fully earned in five years or less. In order to avoid redundant awards, or "re-incenting" the same activity twice, any application for a second EATI award should take into consideration the prior award for the full 7-year period.

For example, a company that promises to grow from 50 to 85 employees by adding five employees per year over a 7-year period could claim its entire award at the end of the fifth year, at which time only 25 total employees would have been added. The cost-benefit model, which establishes a theoretically net fiscally positive award level, however, would have based the EATI award on 7 years of promised economic performance. If this company were to reapply for a new award after 5 years, they could list their starting employment at 75 and be "incented" twice for adding the 10 jobs previously promised in years 6 and 7.

The critical assumption in the cost-benefit model is that job gains are relatively "permanent" and will often persist long after the application period is over. If this occurs, the fiscal benefits to the State could exceed those estimated in the cost-benefit model and give the State a fiscal "cushion."

In practice we have seen that employment and other promised investments upon which EATI awards are based can be quite volatile and may be discontinued at any time. They may rise for a number of years and then flatten out or decline suddenly, as markets and business conditions change. In fact, the pace of economic change and dislocation seems to have accelerated in recent years. Business growth often does not progress along a smooth timeline or persist indefinitely.

Accordingly, the cost-benefit model may be overstating net fiscal benefits from the EATI program by using a 7-year horizon. By using a time horizon that is consistent with that used in claiming the credits (5 years), the State would be better protected against potential fiscal loss.

Such a policy would also insure that companies that reapply 5 years after an initial EATI award would not be affected by issues of double-counting when the new awards are calculated by the cost-benefit model. Given the recent decline in manufacturing employment, there may be an increasing number of such reappli-cations. This raises another issue, outlined in the last

audit, affecting reapplication procedures and the cost-benefit model.

BUSINESS CYCLE SHOULD BE CONSIDERED

Business cycles are a regular feature of the U.S. and Vermont economy. A sluggish economy in recent years has taken its toll on Vermont firms, especially those in the manufacturing sector where most EATI tax credits have been awarded. During the last recession, manufacturing employment in the State dropped by more than 22%.

As a result, some awardees postponed, scaled back, or canceled investments, laid off workers and closed plants. Some firms rejected their awards as unusable. These awards have now been formally rescinded by VEPC.

As the economy recovers, a the cyclical upturn should produce significant rehiring of laid-off workers.

Nothing in the VEPC review process prevents a firm from reapplying (or applying for the first time), after a series of declining years for new credits using a new and lower job base to calculate its "expansion." This could led to awards for job increases that simply "follow the business cycle" and do not represent real net new investment as envisioned in the enabling legislation.

Adjusting for this cyclical factor in the economy could save millions of dollars in cost to this program.

The statute's Guideline No. 1 suggests (but does not require) that applicant employment levels should exceed their "average annual employment level in Vermont for the two preceding fiscal years."[31] This is an inadequate period of time for measuring employment levels.

The average U.S. business cycle is closer to five years in duration than two. According to the National Bureau of Economic Research, which officially dates all U.S. business cycles, the average business cycle duration (from peak to peak or trough to trough) since 1854 is 53 months, almost 4.5 years.[32] The average duration of the last nine U.S. business cycles since 1945 is 61 months, just over five years.

To protect against "incenting" economic activity that is part of the normal business cycle, maximum employment levels should be examined over a time period consistent with the U.S. business cycle, about five years.

RECOMMENDATION 7

The Legislature should require that the cost-benefit model calculate net fiscal costs over a 5-year period instead of a 7-year period to increase the probability of net fiscal benefit to the State and avoid double counting of promised economic activity in the event of a re-application. This will assure that award levels correspond more precisely to the period when the award will be earned.

VEPC should carefully consider reapplications for EATI awards and include prior award analysis and performance to avoid double counting of promised activity. Because the cost-benefit model sets award levels based on seven years of promised economic activity, usually permanent job growth or investment levels, any reapplication for an EATI award should take into consideration the prior award and associated performance promises used to calculate the original award.

VEPC should immediately recalculate and adjust any awards that have been granted that did not take this into consideration.

VEPC should not incent normal cyclical recovery. Rules should be adopted that consider employment history over a time period that is consistent with the duration of the typical business cycle, which is about five years, in determining eligibility and establishing benchmarks for "new job creation."

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31 See §5930a(5)(c)(1).

32 See National Bureau of Economic Research, http://www.nber.org/cycles/, and the U.S. Department of Commerce, Survey of Current Business, October 1994, Table C-51.

FINDING 8

The Economic Progress Council may be granting larger tax credit awards than necessary.

DISCUSSION

VEPC currently offers award levels based on minimally positive fiscal returns over 7 years as calculated by the cost-benefit model. These award levels in some cases may be greater than necessary to help spur a particular investment.

VEPC staff collects and forwards financial details of the proposed project to the cost-benefit model economists. The model is sometimes run on a preliminary basis to determine the maximum amount of credits for which the company can qualify. We were informed that firms have submited revised statistics if not satisfied with the first run of the model.33

There would be no drawback to asking a company as a part of their award application, in advance of the cost-benefit model run, exactly how large a State subsidy is needed to "incent" a given investment. If the amount is below the maximum amount calculated by the cost-benefit model, the activity could be supported at lower cost to the State.

Although there would be no disincentive to exaggerating the need for, and "minimum" size of, a State subsidy, this information would be as reliable as all other applicant attestations, including their "but for" statement, and could in some cases result in lower State revenue exposure with the same beneficial results.

RECOMMENDATION 8

VEPC could minimize program expense by asking all applicants to specify on their applications the award level needed in order to make the investment. If this amount is lower than that later calculated by the cost-benefit model, VEPC could reduce State expense and still achieve the investment result.

The Council should improve efforts to obtain firm data on applications so as to avoid performing multiple cost-benefit model runs.

[33] Discussions with staff of Economic and Policy Resources, Inc., September 10, 2002 and October 29, 2004.

FINDING 9

The Tax Department's four field audits of firms with EATI tax credit incentives were thorough, but did not review job creation or other performance measures specific to the company's EATI award.

DISCUSSION:

An amendment to the statute outlining the Auditor's duties in 2003 requires this Office to verify "any of the inspections done by the tax department of awardees of economic advancement tax incentives to determine the relationship between performance and credits claimed." 32 V.S.A. 163(12).

The Department reports that one field audit of a company with EATI credits was conducted in the 2002 calendar year, and that three were conducted in 2003. The companies were generally selected for sales or use tax issues, and not for reasons related to EATI credits. However, the EATI tax credits were looked at as part of the comprehensive audit. The audits resulted in two companies being assessed a total of approximately $21,800, with one company receiving a refund, and another receiving no change to its tax returns.

Our review showed no indication that auditors specifically examined or verified the specific performance expectations for jobs, wages, investments and other critical goals that allowed companies to earn EATI tax credits. In one audit, research and development expenses were closely examined, however. In none were annual Activity Reports reviewed or verified.

According to the Department, future field audits will review relevant performance expectations.

SUMMARY OF RESULTS OF FIELD AUDITS

Company One: The audit found that in-house and contracted research and development expenses were properly segregated and that credits were earned only for research and development of products for the company itself. However, there was no verification of job creation performance.

Company Two: EATI payroll credit calculations were reviewed, but there seemed to be no review of whether or not the company met its obligations for hiring new workers or maintaining employment.

The audit recommended no change to the company's tax return. It did suggest a personal income tax return audit of the largest shareholder in this Subchapter S corporation. (With S corporations, EATI credits are "passed through" to individual shareholders who can apply them against their personal income liability. S corporations may have one, or many, shareholders.)

The audit noted in its review of the payroll tax credits that if executive payroll was not included in the annual payroll total, the payroll tax credit would be significantly reduced. (Subsequent to the start of this audit, the Legislature passed an amendment to the EATI statute which excludes from the credit calculation the annual payroll for individuals in the firm with more than a 10 percent share of the entity, effective July 1, 2003.)

Company Three: In the course of the audit, EATI payroll and research and development tax credits were reviewed. The payroll credit was found to have included one employee based out of state, but eliminating that payroll amount did not affect the payroll credit amount earned because the payroll tax credit available in that tax year was limited. The audit also determined that certain travel, meals and mileage reimbursement expenses should not have been allowed as research and development expenses. Because of the small effect on the credit earned, and for other reasons, no change to the EATI credit was recommended, though an assessment was made in another tax area.

Company Four: At the time of the audit, the company was in the fifth and final year of its EATI authorization period but had not applied for any of the credits. After the audit was over but before the final report was completed, the company asked the State to amend the corporate work papers to account for the credit. The Department agreed to this request and provided the company with the proper schedules to fill out to claim tax incentive credits in three tax years, and the taxpayer prepared the schedules and submitted them.

In June of 2003, the Department allowed EATI credits for two tax years totaling $428,700, which reduced the company's tax liability. In September, 2003, the Department sent a refund check to the company in the amount of $223,778.20 and closed the case.

In awarding the $428,700 in EATI credits in June, 2003, the Department did not verify that the company met its requirement for creating new jobs in the two tax years.

We also note that the company's own reports show that in the first year, no new jobs were created, and that in the second year, two jobs were eliminated.

RECOMMENDATION 9

The Tax Department should develop a field audit compliance plan that is more responsive to findings and indicators that companies may not be in compliance with significant requirements of the Economic Advancement Tax Incentives Program. It should review and audit all critical performance expectations upon which the award was conditioned.

The Department should share general non-confidential audit findings and recommendations with VEPC which could use the information to educate other companies and their accountants as necessary.

[34] See page 18, Economic Advancement Tax Incentive Program Annual Report, April 1, 2004.

Finding 10

Information provided by VEPC and the Tax Department in their 2004 report to the General Assembly, as required by §5930a(j), is not accurate.

Estimates of net new job growth, investments, and fiscal and economic impacts represent significant overstatements of likely program benefits, and significant understatements of likely net fiscal program costs.

DISCUSSION

VEPC and the Tax Department are required by 32 V.S.A. §5930a(j) to produce an annual report for the Legislature which summarizes economic and program activity that "complied with the performance expectations" of the companies receiving credits. While the agencies have issued annual reports, data contained within the reports is based on incomplete company performance information and assumes the Council has exercised perfect judgment with respect to the "but for" test – that absolutely none of the new jobs would have been created without the incentive.

This has resulted in reports that are inaccurate and exaggerate program performance. There is considerably greater fiscal cost to this program than is acknowledged in the report.

While it is understandable that any agency would want to place its activities in the best possible light before the Legislature and public, we did not find credible the economic and fiscal impacts cited in the EATI report.

The review of the 21 companies found that many omitted critical performance information, such as employment, or filed contradictory performance information in various documents that were not reconciled. Companies (including some with substantial awards) omitted data or filed contradictory information over several years. This information gap costs VEPC and the Tax Department the opportunity to compile accurate statistics on net jobs created, wages and economic and fiscal impacts.

The report may have assumed that if a company was allowed an award by the Tax Department, it met performance expectations. Our audit of the 21 companies showed that most companies claiming and receiving awards did not meet all performance expectations, including such critical expectations as job creation.

"Theoretical" economic and fiscal impacts cited in the report should be discontinued as meaningful yardsticks of performance. The gap between "theoretical" and actual company performance is significant. For example, companies we reviewed promised 3,478 net new jobs but they created only 226.

Without standards for complete reporting of performance information, it is impossible to assess the cost-effectiveness of the program.

The assumption in the most recent program report to the legislature that 100% of "[t]he new job creation and new investments would not have occurred without the incentives authorized,"[34] is also false. It assumes perfect insight with respect to the "but-for" test, which is not possible, and contradicts substantial independent economic research on the importance of state tax subsidies in affecting private investment decisions. Because all claims of net program fiscal benefit in the report rely on this critical assumption, Tables I-F, I-G, I-J, II-G, II-H and II-I in the most recent annual report by VEPC and the Tax Department are not credible representations of program impacts.

Given both current program administration and the requisite assumption of perfect insight regarding the "but for" test (see Finding 4), an honest accounting of this program would probably recognize a substantial real net fiscal cost to the State.

RECOMMENDATION 10

VEPC and the Tax Department should file reports to the Legislature pursuant to 32 V.S.A. 5930a(j) that are based upon complete and accurate information. The data should be based on actual company performance and not on assumed performance, promised activity or claimed credits.

VEPC should discontinue the citation of "theoretical" economic and fiscal impacts that are not meaningful assessments of program performance.

Economic Advancement Tax Incentive Program

BACKGROUND

The Vermont Economic Progress Council, established in 1994 by the Vermont Legislature, originally focused only on long-range economic planning and development of economic policy. With the passage of Act 71 in 1998, the Council was also charged with implementing the Economic Advancement Tax Incentive program.[35]

According to the Vermont Department of Economic Development, which houses the program, the business tax incentive program is "a package of income tax and property tax based incentives that are designed to achieve three goals: create quality jobs; close the wage gap between Vermont and the national average; and maintain and enhance Vermont's quality of life."[36] In brief, eligible businesses pledge to create high-paying, quality jobs and to stimulate new economic activity in Vermont while the State agrees to reduce the businesses' income taxes when the performance goals are achieved and the authorized credit amount is claimed on a state income tax return.

Business entities eligible for the tax incentive program include sole proprietors, C corporations, partnerships, limited liability businesses, subchapter S corporations, or trusts.

The program is more fully explained at Vermont Economic Progress Council website: http://www.thinkvermont.com/vepc/vepc_tax.cfm.

THE INCENTIVES

The Economic Progress Council must, within 45 days[37] of receiving a completed application, approve or deny the following economic incentives in these categories:

Income Tax Credit Incentives

a. Payroll Tax Credit
b. Research and Development Tax Credit
c. Workforce Development Tax Credit
d. Vermont Export Tax Credit/Sustainable Technology Export Credit
e. Capital Investment Tax Credit
f. High Tech Growth Tax Credit
  a. Machinery and Equipment
  b. Technology Infrastructure
  c. Workforce Development
  d. Sales and Use Tax Exemption for Personal Computers and Included Software

Property Tax Incentives

a. Property Tax Stabilization Agreements
b. Allocation of Property Tax Receipts
c. Tax Increment Financing Districts (TIF)
d. Construction-in-Progress Property Tax Exemption
e. Brownfields Property Tax Exemption

Sales and Use Tax Exemptions

a. Exemption for Sales of Building Materials Utilized by Manufacturing Entities

No application fee is charged.

[35] Vermont Economic Progress Council.

[36] Vermont Department of Economic Development web site: www.thinkvermont.com/vepc/vepc_intro.cfm

[37] 32 V.S.A. §5930a(b).

The Awards

As of June 30, 2004, the end of the States 2004 fiscal year, the total of income tax credit and property tax credit incentives authorized was approximately $104 million.

The governing statute calls for the use of a cost-benefit model to evaluate the fiscal impact of proposals and requires the consideration of a number of guidelines related to economic, community and environmental values and principles.

The benefits of the program fall into three main categories, according to VEPC:

1. new high-paying jobs are created;
2. new investments are made; and
3. net incremental taxes are paid to the state.

The Council

A Council of nine voting members is appointed by the Governor to administer the program, review applications, and make awards.[38] In addition to nine voting members, the council includes two regional non-voting members from 12 regions of the state, one designated by the regional planning commission of the region and one designated by the regional development corporation of the region.

As of this report, the Council members are:

Name/Affiliation/Residence	Term Ends
Ms. Minty Conant Lydall Thermal Acoustical, St. Johnsbury	5/15/07
Ms. Valerie Dahl Guilford	5/15/05
Ms. Kimet Hand Jewelry Designer, Manchester	5/15/05
Mr. Chris Keyser Owner Services, Inc., Proctor	5/15/07
Ms. Karen Marshall, Clear Channel Communications, Burlington	5/15/06
Mr. Lawrence Miller, Chair Middlebury	5/15/06
Mr. Carl Rosenquist St. Albans	5/15/06
Mr. William Stritzler, Smuggler's Notch Resort, Jeffersonville	5/15/05
Ms. Mary Lintermann DEW Construction Company Stowe	5/15/07

[38] Economic Advancement Tax Incentive Program Annual Report, April 1, 2004, by the Vermont Economic Progress Council and the Vermont Tax Department, page 2.

THE COST-BENEFIT MODEL

Theoretical cost-benefit fiscal projections are a key part of each application review process. State law requires the Council to apply a cost-benefit model "to determine the return on investment to the state, relative to other applicants, and to assist in establishing appropriate award levels for individual applicants."[39] The law states that the model "shall be a uniform and comprehensive methodology for assessing and measuring the projected net fiscal benefit to the state of proposed economic development activities … and may include consideration of the effect of the passage of time and inflation on the value of multi-year fiscal benefits and costs."[40] The law also says that "any modification of the cost-benefit model shall be subject to the approval of the joint fiscal committee."[41]

The cost-benefit model is maintained and operated by Economic & Policy Resources, Inc., a consulting firm in Williston, Vermont. The foundation of the cost-benefit model is the REMI Model, produced by Regional Economic Models, Inc., (REMI), of Amherst, Massachusetts.

The REMI model estimates the demographic and economic impact of the applicant's proposed economic activity that is the subject of the tax credits.

According to Economic & Policy Resources, Inc., "Applicant economic activity is described to the model by indicating the incremental change in variables such as the number of employees, dollars of new payroll paid, and dollar investment in fixed assets including facilities and equipment and machinery. The REMI component of the model interprets these incremental measures and calculates the anticipated change in total economic activity assuming the applicant's development schedule is followed.

"The REMI model output component then indicates the total increase in population, school-age children, employment, and consumer spending – termed, the 'incremental difference' relative to the control forecast. These data are then employed in the fiscal component of the benefit/cost model to arrive at the estimates of financial measures – state revenues and cost of government services – which are used in the fiscal impact component of the overall benefit/cost model.

"In the last step, the present value of each future year is calculated and the difference between revenues and costs in present value terms describes the net fiscal benefit to Vermont of the incremental direct and indirect economic activity. The costs include both the estimated value of the credits granted to the applicant and the estimated Education, General, and Transportation Fund cost impacts associated with the economic and demographic impacts related to the applicant's project. Costs include State education (per equalized pupil block grant and special education amounts), General and Transportation Fund costs that are estimated on a per person basis. Revenues include personal income, sales and use, meals and rooms, corporate income and miscellaneous fee revenues."[42]

Since the tax incentive program is designed to spur "incremental" job growth and economic activity, the cost-benefit model applies a "background growth" factor to attempt to account for "the underlying level of activity in the industry where there is essentially no influence from these economic development incentives."[43] The types of general industry activity included are payroll growth, research and development expenditures, workforce development expenditures, and other investment spending. Thus, the applicant's industry and regional trend level of growth is "subtracted from the estimated incremental project data presented on the application to determine the level of activity which is treated as incremental in the fiscal benefit/cost model."[44]

THE "BUT FOR" TEST

The so-called "but for" test is critical to the EATI decision-making process and the measurement of net fiscal impacts of a project. The Council is required to review each application and to "ascertain, to the best of its judgment, that but for the economic incentive to be offered, the proposed economic development would not occur or would occur in a significantly different and significantly less desirable manner."[45] (Emphasis added.) Applications that do not pass this "but for" test of the Council are not eligible for economic incentives.

Claiming credits

To claim an incentive, state law requires an award recipient to file a report with the Tax Department and the Council that includes a description of the economic activity, including the total number of jobs created, the number of new jobs filled by Vermont residents, wage levels for the new jobs, and other information.

The Tax Department compares the report to the recipient's performance expectations. The statute says, "Upon determining that an award recipient has met all of the performance expectations, the Tax Department shall allow the tax credit and shall provide the council with a report of the credit amount allowed and the basis for allowing the credit."

Reporting

State law 32 V.S.A.§5930a(j) requires the council to report by April 1 of each year to the Legislature and six different committees regarding the "gross and net value of incentives granted" and data on the awards since the program's inception. The Council also issues periodic updates to the Legislature and the public.

VEPC Operating expenses

The Vermont Economic Progress Council is an independent body that is attached to the Vermont Department of Economic Development, a division of the Agency of Commerce and Community Development, for administrative support.

VEPC Budget

	FY 04 Actual	FY 05 Budget
Operating Expenses	$28,006	$36,332
Per Diem (Board)	$4,050	$5,600
Contracted Services	$30,202	$38,084
Personal Services	*$117,208	$121,179
Total	**$179,466**	**$201,195**

** Personal services include an executive director, and administrative assistant. Increase in operating expenses for FY 05 is result of VEPC taking over as primary licensee for the REMI model and assuming the cost of the primary license formerly paid for by the Department of Public Service.*

The Tax Department and Credit Review

A tax review team was established at the Tax Department in early 2004 to review tax returns where companies and individuals claim tax credits that they earn or apply in a particular tax year. This team consists of a team leader, two corporate tax examiners, one personal income tax examiner, and a field audit supervisor from the compliance division.

[39] 32 V.S.A. § 5930a(d).

[40] Ibid.

[41] Ibid.

[42] "Benefit/Cost Model," Vermont Economic Progress Council, p. 15-16.

[43] Ibid., p. 22.

[44] Ibid.

[45] 32 V.S.A. § 5930a(c).

OFFICE OF THE STATE AUDITOR

PAYOFFS AND LAYOFFS

The High Cost of Business Subsidies

A Compliance Audit of the Vermont Economic Advancement Tax Incentives Program

Administered by the Vermont Economic Progress Council and the Vermont Tax Department

PURPOSE AND AUTHORITY

This report will provide the Vermont Legislature, the Administration, and the public an opinion on the program's compliance with State law and will offer suggestions for new policies and procedures which could reduce financial risk while improving the program's cost-effectiveness and value to Vermont taxpayers.

The Vermont Legislature has mandated that the State Auditor's Office conduct a compliance audit of the program every two years and to report its findings to the General Assembly. Title 32 V.S.A. §163(12) states:

"Duties of the auditor of accounts:

(12) Biennially audit the economic advancement tax incentives program established under chapter 151, subchapter 11E of this title to determine compliance with that subchapter and all other applicable statutes and regulations. The auditor's report shall be made available to the general assembly during the fourth quarter of the second year of each biennium. *The auditor shall include in this biennial audit verifications of any of the inspections done by the tax department of awardees of economic advancement tax incentives to determine the relationship between performance and credits claimed."* (Italicized section added 2003, No. 67, §13c.)

The Vermont Economic Progress Council (VEPC) has authorized businesses $126,698,324 in income tax credits and property tax exemptions or reallocations since the program's start in 1998 through June 30, 2004.[46] Because some incentives are now inactive, the active tax credit authorizations in the program total $104,187,117 for about 150 entities.

A total of $29.5 million in income tax credits has been "earned," that is, the tax credit claims have been reviewed and allowed by the Tax Department as of June 30, 2004.[47]

Through June 30, 2004 companies have applied a total of $13.6 million in tax credits against their Vermont tax liability, and are carrying forward $15.9 million for possible use in later tax years. (This occurs when corporations and individuals do not have sufficient tax liability in a particular tax year to apply the total credits against. Corporations and individuals can carry their earned tax credits forward, according to State law, "to any subsequent year for which an approval exists, or to any of the next five succeeding years following the last year of the term approved by the council for the receipt of incentives." [48])

To date, State government has foregone an average of approximately $2.5 million in tax revenue per year as the result of corporations and individuals applying earned tax credits against their Vermont income tax liability.[49] This amount is expected to increase as the economy improves and more companies have corporate income taxes to pay.

The national Government Finance Officers Association (GFOA) recommends that "A government should periodically estimate the impacts and potential foregone revenue as a result of policies that exempt from payment, provide discounts and credits, or otherwise favor particular categories of taxpayers or service users."

The GFOA also states that governments should evaluate and report on program performance on a routine, publicized basis to keep stakeholders apprised of actual results compared to expectations.[50]

AUDIT SCOPE & METHODOLOGY

The scope of this compliance audit included a review of compliance issues related to the program as established under chapter 151, subchapter 11E of Title 32, entitled "Economic Advancement Tax Incentives."

A compliance audit can be viewed as a type of performance audit as defined by the Comptroller General of the United States. In addition to assessing compliance with legal requirements, a goal of a performance audit may be to "provide information to improve program operations and facilitate decision-making by parties with responsibility to oversee or initiate corrective action, and improve public accountability."[51]

We focused primarily on program activities between July 1, 2002 and June 30, 2004, the last two completed fiscal years for state government. However, due to the complexity of the program, we reviewed some issues before and after the above dates.

The methodology included an examination of the Tax Department policies and procedures in processing and reviewing tax credit claims in corporate and personal income tax returns received before July 1, 2002.

We paid special attention to the question of how the State of Vermont reviews the economic activity a claimant pledged in its application because the fiscal benefits accrue to the State when a company creates promised jobs or makes other promised economic investments.

We selected 21 companies which were allowed over $31,000 in tax credits in the 2002 and 2003 tax years and reviewed the tax credit schedules filed, as well as Vermont State income tax returns, both for corporations and individuals who receive tax credits through S corporations and other pass-through entities.

We also examined work papers related to the four corporate income tax field audits conducted by the Tax Department. We selected seven recent tax credit authorizations by the Vermont Economic Progress Council and reviewed the application files. We also attended several monthly council meetings, including executive sessions.

We reviewed issues concerning the cost-benefit model used by VEPC to evaluate the potential net fiscal benefit, or return on investment, to the State for a given economic project being considered for a tax incentive.

We examined supporting documents including periodic reports by VEPC and the Tax Department on the status of the program, descriptions of computer modeling adjustments, internal correspondence, written policies and procedures, and similar materials.

We conducted interviews with officials at the Tax Department and the Vermont Economic Progress Council, Council members and their cost-benefit model subcontractors.

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[46] Vermont Economic Progress Council, Master Spreadsheet, November 5, 2004. Of this amount, $22,511,207 in tax credits is considered inactive due to rescissions and other factors.

[47] Tax Department, as of June 30, 2004. Note: this total does not include $2,138,912 in linked municipal awards (property tax exemptions) utilized by companies reviewed in this report. See Findings 1 and 5.

[48] 32 V.S.A. 5930h(a).

[49] $13.6 million in tax credits reported applied in six tax years, 1998-2003, by the Vermont Tax Department, as of June 30, 2004.

[50] Practices 11.1 and 9.2c, "Best Practices in Public Budgeting," Government Finance Officers Association, 2000.

[51] Government Auditing Standards, 2.09, United States General Accounting Office, 2003, p. 21.

APPENDIX A

Response by the Department of Taxes

Response of the Vermont Department of Taxes to the December 9, 2003 Draft Report of the Vermont State Auditor's Compliance Audit of the Vermont Economic Advancement Tax Incentive Program

I. THE DEPARTMENT SUPPORTS SIMPLIFYING THE EATI PROGRAM.

Numerous recommendations in the report call for additional controls to be added to the EATI program. Another layer of controls will exacerbate rather than fix the problem. There have been several rounds of legislative additions to the controls. There is now an extremely complex set of rules, such that in our third audit we are sorting out multiple recapture provisions with different triggers, payment procedures and statutes of limitations. Further complications come from distribution of credits through pass-through entities to a series of partners, LLC members or S corporation shareholders. There is an interaction of multiple credits, each with its own accrual rules, tested by separate conditions in performance expectation documents, and further impacted by rules for recapture in the case of substantial curtailments. The resulting system absorbs a tremendous amount of our staff time and staff time of the participating companies.[52] The time has come for the incentives to be restructured from the ground up with better targeting and simpler delivery of the benefits, eliminating the complexities of the current program.

(AUDITOR COMMENT: We agree that the program is excessively complex and difficult to administer and support a comprehensive review and restructuring of the State's efforts to promote quality job growth.)

[52] The Department has one employee dedicated to these credits. A substantial amount of other Department employees' time is also spent on EATI incentives. The Council has only two employees.

II. THE DRAFT REPORT ENTANGLES THE COMPLIANCE AUDIT WITH A CRITIQUE OF THE ESTABLISHED RULES FOR THE EATI PROGRAM.

In addition to verifying compliance with the statute (the requirement of 32 V.S.A. § 163(12) as you note) the report also discusses how effectively the program meets the goal of creating jobs. Because the report, in Finding 1 and elsewhere, intertwines the compliance audit and this program critique, much of the discussion suggests that the Department should have abandoned the legislatively mandated administrative rules for an alternate scheme not yet in statute.

For example, the rule contained in §5930a(k) & (l) requires the Council to provide written "benchmarks," which the Department is required to verify for each year when the credit is claimed. Additional jobs are usually a part of the chosen benchmarks although the Council has considerable discretion and could set the benchmark for the first year to be only the construction of a new facility with the benchmarks for later years requiring additional jobs. Or the Council could determine that the balance of other guidelines in § 5930a(c) outweigh the fact that the company itself is not hiring additional staff. The statute requires the Department to verify that the Council's annual benchmark has been met, not that jobs were created. Nevertheless, the report regularly faults the Department for failure to have controls beyond those chosen by the legislature. Finding 1 is generally a discussion of the fact that the statutory controls are not producing the desired jobs but is headed "The Tax Department and VEPC lack adequate controls. . . as required by statute."

An example of a program critique masquerading as a compliance finding appears on page 11 of the draft report. "Piecemeal credits" (allowing an earned credit such as an investment credit when other authorized credits such as the payroll credit have not been earned for the same year) are stated to be "contrary to [law]". In response to our request for clarification, George Thabault replied that "[t]his is not a shortcoming of the work Tax is now doing to review awards; it is a structural problem with the way the review process was constructed."[53] Although the point seems to be that the law is inadequate the draft states that the Department is not following the law.[54]

Another example is the comment on job retention. The report notes on page 9: "Some companies received EATI credits for payroll growth from jobs created in one year, but then eliminated these jobs in subsequent years with no penalty or award adjustment." The tool the legislature has chosen to penalize a failure to retain jobs is § 5930h(c) (recapture for business curtailment). The recapture is triggered when the job loss reaches 25%. No penalty was applied in the situation you noted because the Department was following the law.[54]

The report should separate the Auditor's observations of the law providing inadequate controls from findings of whether the Department is performing in compliance with the established law.

(AUDITOR COMMENT: The evaluation of compliance, as required by 32 V.S.A. §163 (12), is a necessary component of a program audit, a type of performance audit that is defined by the Comptroller General of the United States in Government Auditing Standards as:

"an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action." [Government Accounting Standards, 2.6, U.S. General Accounting Office, 1994, p. 14.]

Specifically, as outlined in **Government Auditing Standards,** ***program audits may, for example:***

a. Assess whether the objectives of a new, or ongoing program are proper, suitable, or relevant;
b. Determine the extent to which a program achieves a desired level of program results;
c. Assess the effectiveness of the program and/or of individual program components;
d. Identify factors inhibiting satisfactory performance;
e. Determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;
f. Determine whether the program complements, duplicates, overlaps, or conflicts with other related programs;
g. Identify ways of making programs work better;
h. Assess compliance with laws and regulations applicable to the program;
i. Assess the adequacy of the management control system for measuring, reporting and monitoring a program's effectiveness; and,
j. Determine whether management has reported measures of program effectiveness that are valid and reliable.

Our findings and discussions provide information, analysis and recommendations that we believe are critical to improving internal controls, performance, and accountability in a program where Vermonters have invested significant resources to promote jobs and economic development. These findings fall squarely within the Comptroller General's defined parameters of a program audit.

Also: The law does not specify exactly how the EATI credits are to be reviewed, but is clear that "the department of taxes shall compare the award recipient's [activity] report with the performance expectations in the written notification of approval. Upon determining that an award recipient has met all of the performance expectations the department of taxes shall allow the tax credit ..." (see §5930a(l)(1)(B)). Achieving one year of payroll growth and reversing this growth in subsequent years or performing some R&D growth while reducing

[53] December 14, 2004 memo to Tax Examiner Bill Keen.

[54] The other control in the statute, the performance expectations, are annual benchmarks used when each return is filed based on activity at that time. Therefore, they can not be used to consider whether the jobs are retained.

employment cannot be construed as meeting "all performance expectations." This is both a compliance issue and a program critique.)

III. A PROPER CONTEXT SHOULD BE GIVEN TO THE DISCUSSION OF JOBS CREATION.

Finding 1 notes the lack of increased jobs as of December 2003 through the use of selected data. While we don't disagree with the basic finding, the numbers should be given a proper context. The report notes that companies with job reductions have earned $8,092,210 in credits but fails to note that only $4,654,917 of these credits has been actually applied to reduce tax liabilities. Further, the report fails to note that four of these companies, representing $6,114,461 of the earned credits (and $2,881,727 of the applied credits) are either in recapture or being reviewed for recapture through the Council under procedures revised by Act 67 (2003). The recapture review may show that the appearance of job reduction is misleading (for example, a company may have reorganized and transferred positions to an affiliate) or it may result in some or all of the credits being recaptured or disallowed. In either case, the result is an impact far less than drastic as the report suggests.

Also, the significant fact that participating companies increased employment during an economic period when many employers reduced jobs in Vermont is buried in a footnote. Furthermore, the methodology – comparing the number of jobs at the time of the application to the number in December 2003 ignores the effect of any job that was created but lost to the economic cycle. The value of such jobs while they existed and the potential for the jobs to be reestablished in the economic upswing was recognized by the legislature when it established the deferral and mitigation rules, § 5930h(f).

(AUDITOR COMMENT: The Tax Department first requested recapture review for a thirty-seven companies in July of 2004, after the commencement of this audit. The audit period was through June 30, 2004. Therefore the Tax Department's review of recapture took place subsequent to the audit period. However, we will note in the final report that only $4.6 million of the $8,092,210 in allowed credits has been applied by companies, while the remainder has been allowed and could be applied soon. The fact that the 21 companies reviewed increased net employment by 226 jobs over the period under review is not extraordinary. These companies were selected because they took tax credits associated with promises of new economic investment and job creation. That they collected over 65% of the awards granted while creating 6.5% of the jobs promised is a problem. Many good Vermont companies added jobs during the past five years without receiving any tax incentives.)

IV. THE MALLARY COMPROMISE CAN NOT BE IMPLEMENTED.

Finding 2 addresses a compromise offered in the response to the previous audit. The 2003 audit took the position that for credits authorized before July 2000 (when § 5930a(k)&(l) were enacted) the Department should ascertain all projections used in the application and disallow credits if "promises" were unkept. Before specific written performance expectations were established for authorizations after June 2000, it was possible for credits to be earned independently of job creation. The 2000 legislation, Act 159, addressed this by establishing Council-selected "performance expectations" for prospective awards and requiring Department verification of compliance with these annual benchmarks. The legislation did not address authorizations already in place without such specific written expectations. The Department believed the legislature chose not to attempt to make retroactive changes to existing awards. In his response to the 2003 audit, Commissioner Mallary pointed out that requiring every company to be in compliance over each of five years with every projection made at the time of the application would be "devastating for the program and inconsistent with the legislative intent". He also pointed out that the appropriate role of the Tax Department was verification of specific facts, not making economic judgments or speculating on how the Council weighed the various statements in the application when it chose to make an award.

In an attempt to reach a compromise, however, he agreed to ask the Council for specific benchmarks for these authorizations. These benchmarks were to be selected in the same manner as annual expectations for awards after Act 159. He agreed to use such benchmarks for reviewing future claims based on the pre-Act 159 authorizations. The Council has declined

to set such benchmarks. The Council has noted "VEPC does not agree with the Auditor's position that tax credit authorizations approved prior to the change in statute should be reauthorized using the standard put in place by the change in the statute."[55] The Department is no longer pursuing the matter.

(AUDITOR COMMENT: Commissioner Mallary's response to the 2003 audit was no compromise but rather a clear statement of intention: "The Department shall proceed from this point forward on the basis that the language in the award letters made all awards conditional and that the inherent powers of the Department allow it to reduce or deny credits awarded by VEPC.")

V. The performance monitoring and recapture rules applying to income tax credits do not apply to Municipal Awards.

Finding 5 faults the Department and the Council for not applying performance expectation reviews to municipal awards. It does not appear the legislature intended property tax stabilization agreements and other municipal awards to have the same types of conditions or repayments as the income tax credits. Although the statute does not exclude these awards from requirement for written performance expectations, the review procedure, § 5930a(l)(1)(B), refers only to credits. The applicant for these awards must be a municipality, § 5930a(e). However, language for the filing of reports, § 5930a(l), and repayment if expectations are unmet, § 5930a(m)(2), refers to filing of income tax returns and doesn't contemplate awards to municipalities. This may be because the legislature recognized the nature of these awards. For example, a tax stabilization agreement has no effect unless the property is built and, even if the property is not occupied as expected, the municipality and education fund will benefit from the new property being on the grand list when the stabilization ends.

(AUDITOR COMMENT: Municipal awards are identified as credits in the EATI Annual Report prepared by the Tax Department and VEPC, and are linked to company awards in the cost benefit analysis which sets all award levels. Therefore these credits must be linked to performance or they will continue to represent a large cost to the State.)

VI. The recommendation for basing awards on only incremental activity should not be limited to the R&D credit.

Finding 6 adopts a Department recommendation that was noted without comment in the 2003 report. Promises to Keep, Appendix K. Although we used the R&D credit as an example, the issue is identical with the capital investment credit, the workforce development credit and the credit for increased payroll.

(AUDITOR COMMENT: We agree and have modified Finding 6 accordingly.)

VII. The annual report to the legislature was appropriate.

Finding 10 implies that the VEPC annual report was inaccurate. The report accurately conveys data reported on tax returns. As with any report, the data may differ from subsequently audited data. The Council's use of the but-for assumption and the reporting of "theoretical" impact of the program is fully disclosed and is consistent with earlier reports.

(AUDITOR COMMENT: While there is full disclosure with regard to the critical "but for" test assumption underlying all "theoretical" benefits, this assumption is not accurate. Accordingly, none of the ensuing data and analysis based on this assumption is accurate. The statute does not call for estimates of "maximum possible benefits" or "theoretical benefits;" it mandates accurate information based on credible assumptions.)

VIII. The report incorrectly analyzes the statute of limitations.

Finding 2 incorrectly suggests that there may be a conflict between the three-year statute of limitations for adjusting tax liabilities (§5882) and the six-year recapture schedule for curtailments (job reductions over 25%) in section 5930h(c). There is no conflict and, in some cases, a recapture penalty may be assessed even nine years after the credit was originally applied. This is because the statute makes the recapture amount a liability in the year of the job loss, not an adjustment to the earlier return on which the

credit was earned. The statute begins to run from the filing of the return for the year in which the job loss occurred, not the year the credit was applied.[56]

(AUDITOR'S COMMENT: Issues associated with the statute of limitations are complex and are further discussed in Appendix F, Opinion: Statute of Limitations, by Attorney Mitch Pearl. As Pearl suggests, this statute could benefit from legislative review and clarification.)

[55] November 1, 2004 letter from Fred Kenney to Secretary of Commerce Kevin Dorn.

[56] 5930h(c)(2). In addition to the recapture provision for job curtailment, there is a provision requiring a business to repay a credit if it fails to file a required report, fails to provide required information, knowingly provides false information, or is subsequently found out of compliance with a performance expectation for a previously allowed credit. 5930a(m)(1). The period for assessments under this provision is defined in § 5930a(m)(2) and is unrelated to the six-year schedule for recaptures required by job curtailment. In addition to the recapture provisions for a correctly claimed credit, a credit that is miscalculated or otherwise incorrect can be adjusted in the same manner as any other error on a return, within three years from the date the return is filed.

APPENDIX B

Response by the Vermont Economic Progress Council

Response to the 2004 State Auditor's Review of the Economic Advancement Tax Incentive Program by The Vermont Economic Progress Council

SUMMARY RESPONSE

The Vermont Economic Progress Council ("VEPC" or "the Council") herein submits their response to the 2004 Draft Report ("the report") of the State Auditor concerning the internal control and compliance review of the Economic Advancement Tax Incentives (EATI) program.

CRITIQUE OF PROGRAM STATUTE RATHER THAN COMPLIANCE AUDIT

Like the 2002 audit, much of this report focuses on the Auditor's opinions about this type of program and is a critique of the how the program is structured in statute rather than how statutory requirements are being administered. It is largely a statement of the Auditor's position on policy decisions rather than constructive recommendations and suggestions to the administrating agencies on how to better comply with statute and improve operations. While the generalizations and assumptions presented in the report as facts might support the report's position on tax incentives, they do not help determine the level of compliance with the statute or provide solutions to strengthen administration.

Instead, the critique suggests ways that the administrating agencies should have applied legislative mandates that were not in place at the time and it assumes policy decisions that should have been made by the legislature. This perspective is evidenced by the repetition in this report of several findings from the previous report (findings 3, 4, 7 and 8).

The recommendations made in those findings in 2002, and again here, are not about the administration of the program by VEPC and the Tax Department. They are about how the program is structured in statute. The administering agencies cannot change that through corrective action. Only the General Assembly can make such policy decisions and they chose not to after the previous audit.

(AUDITOR COMMENT: The evaluation of compliance, as required by 32 V.S.A. §163 (12), is a necessary component of a program audit, a type of performance audit that is defined by the Comptroller General of the United States in Government Auditing Standards as:

"an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action." [Government Accounting Standards, 2.6, U.S. General Accounting Office, 1994, p. 14.]

Specifically, as outlined in Government Auditing Standards, program audits may, for example:

k. Assess whether the objectives of a new, or ongoing program are proper, suitable, or relevant;
l. Determine the extent to which a program achieves a desired level of program results;
m. Assess the effectiveness of the program and/or of individual program components;
n. Identify factors inhibiting satisfactory performance;

o. Determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;
p. Determine whether the program complements, duplicates, overlaps, or conflicts with other related programs;
q. Identify ways of making programs work better;
r. Assess compliance with laws and regulations applicable to the program;
s. Assess the adequacy of the management control system for measuring, reporting and monitoring a program's effectiveness; and,
t. Determine whether management has reported measures of program effectiveness that are valid and reliable.

Our findings and discussions provide information, analysis and recommendations that we believe are critical to improving internal controls, performance, and accountability in a program where Vermonters have invested significant resources to promote jobs and economic development. These findings fall squarely within the Comptroller General's defined parameters of a program audit.)

CONCLUSIONS ARE BASED ON MISPERCEPTIONS AND DATA FROM A SMALL SAMPLE, SOME OF WHICH IS INCORRECT AND USED IN A WAY THAT IS MISLEADING

The report's confused position on how the program should be structured in statute with how it was or is structured is exacerbated by the development of conclusions that are based on misperceptions, misleading statements, partial or incorrectly applied data, and statements that omit pertinent information.

The report includes generalizations about the administration of the EATI program that are based on a few examples or exceptions. The same is done regarding the economic and fiscal impact of the program. Statistics from a "sample group" of 21 companies, which represents only 14% of the 150 active projects, are used to justify generalizations about the program and its economic and fiscal impacts.

Some of the numbers cited in Finding 1 are incorrect because of the way the base data is utilized. Also, the way those numbers are used to support conclusions is flawed. For example, the report states that the sample group "promised" to create 3478 jobs during the time period reviewed. Actually, those companies projected the creation of 2868 jobs during the review period. The report number includes job creation projections through the end of 2004, which is not the period through which credits were allowed (2002 or 2003). The report also omits the fact that if the companies in the sample group had created all the jobs and made all the investments projected, they would have earned over $35 million in tax credits rather than the $18 million earned.

More importantly, the data from this limited sample are used to conclude that the program represents a cost to the State or a "direct public expenditure." Whether these tax credits represent a cost or benefit cannot be determined simply by dividing the net number of jobs created during one period into the amount of credits earned during a different period. The total amount of ***all*** new economic activity generated must be determined for the same period during which credits were ***applied*** against tax liability. The gross amount of new revenues generated by that activity has to be calculated and then the costs of the credits and other indirect costs subtracted to get the net revenue benefit or cost. If the net result is positive, it is not a cost or expenditure. The accuracy of any data can be debated, but the report should not conclude that the program represents a cost to the State based on a sample of 21 companies and based on a flawed use of the data from that sample.

The data available for the 2004 Annual Report on the total EATI program through 2002 shows the creation of 1783 net new jobs, the retention of 7719 jobs (an indirect benefit), $429 million of investment in Vermont, and a ***net revenue benefit*** of $9 million for the State.

The report includes a brief mention that "some procedures have been improved," but the report includes statements, assumptions, and conclusions that completely ignore the improvements that have been implemented. The report does not recognize that as legislative changes were made to the program, the administering agencies implemented those changes.

The report is also rife with terminology that is incorrect, and more often, misleading. The terms

tend to leave the reader with impressions of the program that are not true and therefore illustrate a lack of understanding of the program. For example, several Findings refer to company projections as "promises." Companies cannot promise the creation of a particular number of jobs or level of investment. The applicants are ***projecting*** new activity that might occur in Vermont ***if*** the incentive is authorized. The program is now designed so that the company only gets to reduce their tax liability if a certain level of the projected new activity occurs. That level ensures that the State is getting back more from the sources of revenue that are increased by the new economic activity than the State is foregoing from a reduction in the company's income tax liability or property tax liability. Prior to the addition of annual performance expectations to the program in 2003, there was no required level of annual performance, only the understanding that the credits that could actually be earned would be commensurate with the actual activity (or performance) that occurred.

Another misleading term used is "property tax exemption." Some of the data utilized and some report conclusions could lead the reader to believe that all the property tax incentives that are part of the EATI program exempt a company from paying their education taxes. This is simply not true. The only incentive that allows a company to ***temporarily*** suspend their education tax liability is the Construction-in-Progress Property Tax Exemption. Under this exemption, a company does not pay education taxes on a building that is being built until it is 75% completed or occupied. The exemption is limited to two years. The other property tax-related incentives either reduce the education tax paid on ***new*** liability due to an expansion or renovation (stabilization) or do not reduce the liability to the company at all (Allocations and TIFs). Under Allocations and TIFS, the incremental education taxes generated by new economic activity (i.e. renovations, expansions) are utilized by municipalities to pay for infrastructure that is required for the economic activity to occur. The education tax liability to the company involved is not exempted or reduced.

Also, the report uses the term "subsidy" when referring to an incentive. This is misleading because it could cause the reader to believe that the EATI program provides an immediate cash benefit or reduction in tax liability. This, of course, is not the case. The report utilizes the term based on the report's unsubstantiated invalidation of the 'but for' and the flawed assumption that because tax credits were allowed for activity that did not meet the applicant's "promised" level of activity, the claimed credits represent a "cost" to the State. As stated earlier, applicants project activity, they do not promise it. The credits that were allowed were commensurate with the level of activity that actually occurred and were allowed in accordance with the statute in place at the time. The credits allowed were for activity that generated economic activity that in turn generated new revenues to the State. Therefore, all the credits allowed cannot be assumed to represent a cost to the State.

(AUDITOR COMMENT: An audit includes examining, on a test basis, evidence supporting the amounts in question, in this case tax credits earned by participating entities. The 21 companies audited represent 100% of the firms which were allowed substantial income tax credits in the 2002 and 2003 tax years, the period of this audit. These companies were allowed a total of $18.8 million in income tax credits, which represents approximately 65% of the tax credits earned by all companies since the program in 1998, through June 30, 2004. This sample is appropriate for compliance audit purposes.

Also, there was only one company where job creation projections through 2004 was used, not all companies as this response suggests. Jobs data can differ because some annual Activity Reports sent to VEPC by companies featured job data that was incomplete or contradictory. We used more recent Tax Department information, and we recognize that VEPC does not have ready access to this information. The projection totals used in our report are accurate.

With respect to fiscal costs, the costs represented are direct public costs resulting from foregone income tax revenue. Net fiscal costs can only be determined by making assumptions about the extent to which the EATI subsidies actually caused the investments to occur and re-running a cost-benefit model using actual performance data. Even accepting the extreme assumption that no project would have occurred in part or whole "but for" the EATI credits (as VEPC does), we do not believe the actual performance of these 21 companies could result in a positive net fiscal impact. We would encourage VEPC to perform a cost-benefit model run using the actual performance

data for these 21 firms (including all investments and payroll by company) and the actual credits allowed if they believe otherwise.

A subsidy describes a fiscal net negative situation, and due to program performance to date and the weakness of the "but for" test to determine fiscal neutrality, this report describes a range of net negative situations. The Minnesota State Legislature, in writing a law that requires more accountability and reporting on state tax incentives, recently defined a subsidy this way:

"A subsidy is a state or local government agency grant, contribution of personal property, real property, infrastructure, the principal amount of a loan at rates below those commercially available to the recipient, any reduction or deferral of any tax or any fee, any guarantee of any payment under any loan, lease, or other obligation, or any preferential use of government facilities given to a business.")

FINDINGS ATTEMPT TO REWRITE HISTORY

One of the most conspicuous problems with the report is the repeated reference to actions or circumstances that occurred prior to changes in statute. The report attempts to impose the changes on those circumstances after the fact. Many of the legislative and administrative changes to this program were developed by VEPC and the Tax Department. One of the facts never mentioned in the report is that all legislative changes enacted have been implemented by the administering agencies. The report looks at past actions and circumstances through the lens of current statute, creating a blurred vision of what should have occurred.

For example, in Finding 1, while referring to credits authorized prior to 2003, the report cites a provision in 32 VSA Section 5930a(l)(1)(B) that was not added until July 2003. The provision requires a review by VEPC if the Department of Taxes cannot determine compliance with annual performance expectation benchmarks, which were also required after July 2003. This provision was not in place when the credits were authorized or during the time returns for the "sample group" were examined by the Tax Department. Yet the report states that an action required by the provision was not followed. It could not be followed at that time because it was not yet in statute.

This occurs again in the Finding 2 discussion regarding "collecting essential company performance information." As the program has evolved and been amended by statute, the requirements for the information collected from companies has changed. As those changes occurred, administrative improvements were made to collect the pertinent information. The report leads the reader to believe that the administrating agencies should have known what information needed to be collected and should have collected that information even before the changes were made to the program that required gathering the new information.

(AUDITOR COMMENT: Since the inception of the VEPC EATI program there have been performance expectations associated with award allowance. These have become progressively more detailed in statute because the administering agencies have failed to insure even "theoretical" fiscal neutrality in their administration of the program. The returns for the 21 companies sampled all involved claims for awards in 2002 and 2003. The statute in effect at the time the claims were made should have disallowed many of the claims reviewed.)

The most troublesome case of the report rewriting history involves the issuance of Performance Expectation Documents containing specific annual performance benchmarks. This requirement was not in effect until July 1, 2003, yet many of the report conclusions are based on the incorrect assumption that this provision existed from the beginning of the program. This misconception, coupled with the incorrect distinction between projected activity and activity required to ensure a return to the State, is the basis for most of the erroneous conclusions in the report.

(AUDITOR COMMENT: Performance expectation documents were required by statute as of July 1, 2000, not July 1, 2003. Annual benchmarks were added in 2003. Prior to these statutory clarifications, there were clear statements that award achievement was predicated on company achievement of projected economic activity. Companies received approval letters which stated, "As you know, in order to claim the credits, [you] will have to actually perform and make the investments as noted in the application." In June of 2000, VEPC informed all previously approved applicants that they were required to submit annual

reports to the Tax Department and VEPC on new jobs, wages, and investments so that VEPC and the Tax Department could "assess the performance of the award recipient." The requirement for companies to meet performance expectations before claiming tax credits has always been an essential component of the program.)

Almost all of the changes and improvements to this program were conceived of and implemented administratively by VEPC and the Tax Department or suggested by VEPC and the Tax Department and enacted by the legislature. Once enacted, both administering agencies have implemented changes to comply with the statutory changes. Unless specifically directed by the legislature through a retroactive provision, we cannot legally go back in time and apply changes to past circumstances.

(AUDITOR COMMENT: The Council is incorrect. In January 31, 2003, then-Tax Commissioner Mallary stated: "The Department shall proceed from this point forward on the basis that the language in the award letters made all awards conditional and that the inherent powers of the Department allow it to reduce or deny credits awarded by VEPC." To date, the Tax Department and VEPC have failed to develop adequate controls to carry out the Commissioner's directive.)

Recommendations regarding compliance already resolved

The report includes 35 recommendations, only five of which are concerned with the way VEPC currently administers the program, with another 13 directed to both VEPC and the Tax Department regarding current operations and administration. Of these, only two issues that impact VEPC's role remain unaddressed by previous legislative changes or administrative improvements.

The Council agrees that there are issues remaining to be resolved regarding municipal awards (Finding 5) and reapplications (Finding 7). Steps have been taken to address these two issues but solutions have not yet been fully implemented.

The remaining recommendations are concerned with the Auditor's perception of the program's structure in statute.

Adds complication rather than simplification

One of the stated goals of the 2002 audit was to make suggestions that would simplify the administration of this program. The 2002 report failed to accomplish that goal and this report contains no constructive suggestions to simplify the program's administration. Instead, the report suggests the addition of more administrative requirements for the agencies and applicants. One of the few positive statements included in the report concerns how the program is too burdensome for current agency staff levels. However, the audit fails to make any suggestions regarding how to address that and only suggests steps that will increase that burden.

Overall, the report relies on a limited sampling, incomplete information, and assumptions to make claims that are misleading, incorrect or are generalizations about the program that are based on exceptions rather than the rule. Included below are responses to each Finding and Recommendation that provide details to support this viewpoint.

(AUDITOR COMMENT: We support the overhaul and simplification of this program, and recommend that the Legislature place a moratorium on all new awards until this can be achieved.)

Response To The 2004 State Auditor's Review of the Economic Advancement Tax Incentive Program by the Vermont Economic Progress Council

DETAILED RESPONSE

FINDING 1

The Council does not dispute that the companies in the "sample group" earned $18.8 million in tax credits and have applied $6.9 million against tax liability. However, the Finding misrepresents the meaning and impact of these figures and implies that the statute in effect at the time was not complied with.

This and other Findings in the report make the incorrect assumption that first, any credits claimed are a cost to the State and second, that companies must create all jobs and make every investment projected in order for the State to realize the benefit projected by the cost-benefit model.

Credits earned can only be ***assumed*** to represent a cost to the State if no activity occurred to earn the credit or if all the activity would have occurred without the incentive. The program relies on the Department of Taxes to verify that investment activity actually occurred before allowing a credit to be applied against tax liability. VEPC acknowledges that a certain level of particular activity must occur when credits are earned and applied in order for the project to result in a net positive revenue impact for the State. There are many ways to monitor whether the overall level of activity that occurred meets that goal.

Until July 2003, the Department of Taxes was to verify investments and job creation and utilize "all records and information necessary" to determine whether the level of investment and job creation was sufficient. The method the Legislature chose to utilize when the program was amended in 2003 was to require annual performance expectation benchmarks. However, the reader should not assume this means that a company must perform exactly as projected in an EATI application. The applications set out projections, the cost-benefit model shows the theoretical amount of credits the company could earn if the projected activity occurs and calculates the revenue impact of that activity for the State. If a company does not create every job and make every investment to the level projected, that does not automatically mean there will not be a positive revenue impact for the State.

Again, the Council agrees that there must be a certain level of activity for the State to realize a positive return. There are critical projected activities that must occur – job creation and capital investment – to generate the offsetting revenues. But that is not the same as the statements made in the report, which can lead one to believe that all projected activity (incorrectly called "promises" in the report) must occur for any credits to be earned. A simple example would be if a company projected the creation of 20 jobs at an average wage of $30,000 over five years. If the company actually creates only 15 jobs at an average wage of $45,000, the job creation projection is not met, but the economic and fiscal impact of that investment for the State is actually more positive.

The fact that a credit is earned does not automatically incur a cost to the State. The activity that generated the earned credit resulted in some level of new offsetting revenues to be generated. Additionally, for the earned credit to impact State revenues, it has to be applied against a company's tax liability. That does not always occur if a company is not profitable or the tax liability is not sufficient to apply the entire earned amount. Through 2002, $28 million in credits had been earned and $12.7 had been applied against tax liability. The remaining $15.7 million is in carry-forward and no one can predict when or if those credits will be applied.

(AUDITOR COMMENT: This is true. However, with corporate profits rising in the last 18 months, the probability of credit use increases and could easily double or triple direct program costs.)

Finding 1 is incorrect with respect to the existence of controls to enforce performance requirements of authorized companies. Until the amendment in 2003, the Department of Taxes was to verify investments and job creation and access and utilize "all records and information necessary" to determine whether the level of investment and job creation was sufficient. The program statute was amended by the Legislature effective July 1, 2003 (Act 69) requiring that VEPC provide detailed annual performance expectation benchmarks. The provision further required that in addition to ensuring that investments actually occurred (verification), the Tax Department must also compare actual activity to these expectations (compliance) before allowing credits to be applied against tax liability or carried forward. Since this amendment was enacted, VEPC has been providing Performance Expectation Documents that contain detailed annual performance expectation benchmarks to the authorized companies and the Tax Department. The Tax Department must continue to verify and now must also conduct performance expectation compliance comparisons before allowing credits. There is evidence that this has occurred since the change in statute because VEPC has recently received some Performance Expectation review requests from Tax.

The data utilized in Finding 1, relating to the 21 companies in the "review group" is flawed in its generation and utilization. First, the report fails to mention that if the companies in the group had created all 3,478 jobs projected and made all investments projected, they would have earned $35,280,191 in credits rather than the $18,800,000 actually earned. The $35 million represents the theoretical amount of credits based on the projected activity. The amount of credits actually earned is relative to all the actual activity that occurred.

(AUDITOR COMMENT: The $20.9 million in credits allowed (this figure includes linked municipal awards) represents more than 59% of the above $35.2 million VEPC claims are possible credits these companies could have "earned." Meanwhile, actual job creation was less than 7% of projected levels. Even considering other capital investments made, the amount of credits allowed is not even close to being proportional to "the actual economic activity that occurred.")

Also, as the report footnote states, the report's calculation "assumes" all earned credits will eventually be applied. The history of the EATI program shows that this is not necessarily true because some of the credits are not applied in the year earned and some are never applied. If this happens, the State gets the benefit of the activity and does not incur the cost of the credit.

Further, by the time the earned credits are applied, the company could add to its workforce or the credits could be disallowed and/or recaptured. In fact, the Council has taken action to disallow and require the recapture of credits of one of the companies in the sample group and has three other companies in the group under review. These reviews were initiated and are proceeding in accordance with statute.

The report uses a flawed method to calculate the number of jobs projected by the sample group when compared to the amount of credits allowed for that group. The number of jobs calculated in the report is 3,478. This is the number of jobs these companies projected they would create by the end of 2004. The amount cited as tax credits allowed are through the end of 2002 or 2003, depending on the last tax return examined by the Tax Department. The report incorrectly compares the jobs projected for one period against the credits allowed for another period. If the same period is used, the amount of jobs projected is 2868. While this number still seems high when compare to the number of jobs actually created by the sample group, the reader should keep in mind that the actual amount of credits earned is also much lower than the amount of credits that would be commensurate with the creation of 3478 jobs. Further, the amount of credits allowed is not based only on job creation. These companies made millions of dollars in investment to earn the credits as well.

A further distortion results from the amount of foregone education tax liability represented by the report. The report includes data in the "estimated exemptions utilized by companies in the group of 21 reviewed" that should not be represented as exempt or utilized. The companies involved in Property Tax Allocations or Tax Increment Financing Districts are not exempt from education tax liability. They pay the full amount of education tax on new buildings built or renovations made. The incremental education

tax revenues are retained by the municipality to pay for infrastructure required for the new economic development to occur. The education tax is not foregone until the municipality spends it on the infrastructure. The amount of education fund revenue that should be used for the sample group is actually $21,478.

(AUDITOR COMMENT: Foregone Education Fund property tax revenue data was provided by the Tax Department Division of Property Valuation and Review. It is important to note that even if a company redirects its State property taxes to a municipality, this represents a revenue loss to the State. As such, it is relevant to include as a program cost to the State and totals more than $2 million to date, not $21,478.)

A major piece of misinformation in this finding is the calculation of the "public expenditure per job created." Regardless of the veracity of the data, the calculation in the report completely disregards the actual amount of credits that have been applied against tax liability by these companies and ignores the revenue benefits the State has gained from the jobs created and investments made. The calculation should use the amount of tax credits applied, not the amount earned. The 21 companies in the "test group" have applied only $6.9 million of the $18.1 earned. This calculation cannot assume that the remaining credits will eventually be applied to reduce future tax liability. If the calculation is properly done using the adjusted Education Fund impact and the actual General Fund impact to date (amount applied), the "direct public expenditure" per job is actually $30,808.

However, even this calculation fails to recognize the revenue benefit generated by the jobs created and investment made by these companies. Whether the credits represent a cost or benefit cannot be determined simply by dividing the net number of jobs created into the amount of credits applied. The total amount of ***all*** new economic activity generated must be determined for the same period during which credits were ***applied*** against tax liability. The gross amount of new revenues generated by that activity has to be calculated and then the costs of the credits and other indirect costs subtracted to get the net revenue benefit or cost. If the net result is positive, it is not a cost or expenditure. Given the short amount of time allowed to respond to this report, we cannot conduct the research required to calculate that figure for just the sample group. But it should not be assumed to be a net cost to the State. In fact, the 2004 Annual Report for this program indicates a positive net revenue impact of almost $10 million for all activity through 2002 (not for this group alone).

The calculation also assumes that the 226 figure cited in the report as net jobs created is correct. We question the validity of this number given that we found that some of the starting employment numbers are incorrect and the end numbers are from sources that we have found to be inaccurate. The Council calculated 514 jobs created according to the last available information from the companies. The difference between these numbers is mainly from two companies for which the latest information is not yet available. VEPC and the report obtain the data from different sources so there is no way to possibly reconcile the difference.

(AUDITOR COMMENT: We recognize that VEPC does not have access to all of the Tax Department data we used to estimate employment levels, and we consider our estimates to be the best possible. If anything, the net new jobs figure of 226 may be high for three reasons: 1) We used DET data when information was not supplied by the company. Since DET counts include part-time workers as well as full-time workers (the standard for the program), these estimates probably overstate actual employment levels; 2) None of the employment data were independently verified or audited. All company representations, except when contradicted by tax form submissions, were accepted as true. This probably presents an upward bias to the employment estimates. And, 3) Starting point numbers in some VEPC applications (especially those at the beginning of the program) allowed jobs already in place at the time of the application to be included as "net new jobs." This obvious violation of the "but-for" test was not unusual early in the program and presents an upward bias in the employment estimates we used.

Whether there are 226 or 76 or 514 net new jobs would not change the primary findings in this report.)

There are also examples in Finding 1 of information that is omitted. The report fails to explain that at the time the returns for the 21 companies in the sample group were being examined, the statute

did not contain the requirement for specific annual performance benchmarks. That requirement was added to the program in 2003 and has been implemented for authorizations made after the date of enactment. At the time the returns for these authorizations were examined by Tax the statute contained a recapture provision for instances where a company fell below a certain level of employment. The companies in this group did not necessarily fall below that level. Those that have had a substantial reduction in employment are under review for disallowance and/or recapture. The report also fails to recognize that VEPC has taken action to disallow the credits of one of the companies in the sample group and requested that Tax recapture any applied credits.

To use questionable data from the 21-company sample group, to make the broad statement that "non-performance is widespread" is a gross exaggeration. A 14% sampling is not the basis for such a statement. Also, as mentioned earlier, not reaching projections does not constitute "non-performance." That would assume that the companies were earning a credit relative to the projected activity instead of the credit being calculated on the actual activity. "Performance" should be measured against the level of activity that ensures a return for the State. That level is not the same as projections.

The report cites Section 5030a(m)(1)(A-C) and lists several ways the Tax Department did not comply with that section when allowing credits. This is another example of the report applying a statute change to circumstances that occurred prior to the change. That section was changed in 2003 to refer to subsections (k) and (l), which contain the requirements for specific annual performance benchmarks and an annual review of performance against those benchmarks by Tax. That requirement did not exist when the returns of the sample group were examined.

This section also states that credits were allowed for companies who did not file "timely annual Activity Reports." Had the records on this issue been examined, they would show that very few companies fail to file an Annual Activity Report. Those that have not filed the reports have had their credits rescinded (as the report notes in footnote 15).

VEPC agrees that the allowance of one earned credit and the activity required to earn it cannot be divorced from other activity and credits. It has never been the Council's position or intention that the Tax Department should allow credits in a "piecemeal fashion." The activity that impacts the revenue benefits to the State – incremental payroll and capital investment – must occur at a certain level for the State to realize a return from other revenue sources that offsets the foregone income tax revenue. While the credits can be calculated on an individual basis, whether they should be allowed depends on whether or not the economic activity generating the offsetting revenues occurs.

The last paragraphs under the "Non-compliance" section of Finding 1 are another example of citing statute that did not exist when the returns of the sample group were examined. The Tax Department could not have complied with the provision to "request that the council conduct a more detailed review" because that provision did not exist until July 2003. Now that Tax is examining returns for projects that were issued annual performance expectation benchmarks, they are sending notices to VEPC for performance expectation review.

RECOMMENDATION 1

The Council points out that only the Tax Department can "allow" tax credits. From the beginning of the program until July 2003, the Department of Taxes was to verify investments and job creation and utilize "all records and information necessary" to determine whether the level of investment and job creation was sufficient. VEPC played no part in reviewing tax returns and allowing credits prior to July 2003. After the effective date of Act 69 (July 1 2003), VEPC became involved by providing annual performance expectation benchmarks and providing a review if Tax cannot determine compliance with performance expectations. To include "VEPC" in the first and third parts of this recommendation shows a misunderstanding of the program's administration or it is another example of the report misleading the reader.

(AUDITOR COMMENT: VEPC has always had a role in program administration and rule making, including the development with the Tax Department of the program system for award review. As such,

it bears some responsibility for the administrative shortcomings of a system that has allowed tens of millions of dollars in credits for companies that have not performed at a level that would justify even a theoretical net fiscal benefit to the State.)

This recommendation fails to recognize that the statute was changed in 2003. Since that change, VEPC has provided Performance Expectation Documents (PED) to the authorized companies and the Tax Department that include annual performance expectation benchmarks that are based on the cost-benefit model results underlying the authorizations. The Tax Department has utilized these PED's to review returns and has requested some reviews by VEPC as appropriate and where required by statute. Credits cannot now be allowed in "a piecemeal fashion" because if one performance requirement is not met, VEPC will review all credits claimed that year and the relative performance requirements.

Since the controls required by Act 69 in 2003 to enforce performance expectations are in place, there is no need for a moratorium on new awards.

(AUDITOR COMMENT: We disagree. Commissioner Pelham, in his response to the Draft Report, states that the so-called "Commissioner Mallary compromise," which would require basic performance expectation information for all awards, "cannot be implemented." Commissioner Pelham cites the Council's refusal to develop reasonable performance benchmarks for companies that received EATI awards prior to July, 2000. Commissioner Pelham also notes, "[The Tax Commissioner] agreed to use such benchmarks for reviewing future claims based on the pre-Act 159 authorizations. The Council has declined to set such benchmarks.")

FINDING 2:

The Council flatly disagrees with the Auditor on this issue. There was no requirement, "guidance," direction or intimation by the Legislature that annual performance expectation benchmarks were to be provided retroactively for authorizations made before the requirement was enacted in July 2003. VEPC has complied with the requirement to provide Performance Expectation Document's with annual performance benchmarks since the passage of the amendment.

In fact, the Act expressly stated when the new benchmark provision shall take effect and expressly stated that some other provisions shall be retroactive. The enactment clause (Section 26) of the bill stated, "Sections 8 through 23d, relating to the procedures and authority of the Vermont Economic Progress Council (VEPC), ***shall take effect July 1, 2003,*** except the provisions of Section 21, amending subsection 5930h(a) of Title 32, relating to carry-forwards, and Section 21a, adding subsection 5930i(c) of Title 32, relating to credit allocations of S corporations, shall take effect from passage and apply retroactively to January 1, 1998." (Emphasis added). The requirement for annual performance expectation benchmarks was contained in Section 12a of the bill.

The requirement for annual performance expectation benchmarks did not exist until July 2003, when the legislature – the only State entity that ***can*** require such a change – enacted Act 69. Therefore, the statement in the second paragraph of Finding 2 is another example of distorting the truth and confusing cause and effect. The Tax Department did not allow millions "in tax credits without having verified whether companies created promised jobs, made promised investments or achieved other critical performance expectations" ***because*** Tax and VEPC failed to develop clear performance expectation documents for these awards. They allowed the credits in accordance with the statute that was in place at the time.

Former Commissioner Mallory may have made a "commitment" to the Auditor to develop performance expectation standards for the authorizations from the period before such standards were required by statute. However, the statute gave the responsibility to develop the performance expectation benchmarks to VEPC and included no mention of retroactivity in the statute. The report is incorrect and misleading to state that Commissioner Mallory's "determination made it clear that all the relevant branches of State government involved with the tax credits were finally 'on the same page' regarding the need for the State to determine whether a tax credit recipient has complied with performance expectations."

First, Commissioner Mallory made this commitment in the Department's response to the

2002 audit. VEPC had no opportunity to provide input. Second, the issues of annual performance expectation benchmarks and the allowance of credits by the Tax Department prior to the change in statute have to be separated from each other. There may be other reasons those credits should not have been allowed by Tax, but those reasons have nothing to do with non-compliance with benchmarks that did not exist. There were other methods in place to allow Tax to measure compliance at that time.

To clarify this issue and since it is the basis for much misinformation in the report, the Council has prepared a chronology of events related to the requirement for annual performance expectation benchmarks. The chronology is included as Appendix A to this response.

The report also incorrectly states that applied credits cannot be recaptured. There has never been a requirement in statute for recapture for not meeting projections (incorrectly termed "promises" in the report). There is now a requirement for not meeting performance expectations. There was, and still is, a requirement for recapture for severe employment reductions. In several places, the report confuses these two separate requirements. In another example of omitted information, the report also fails to mention the credit disallowances and recaptures that have already occurred or that are currently under review for this purpose.

This is the first the Council has heard of the issue regarding the three-year limitation that could prevent a recapture by the Tax Department. While VEPC can rescind credits, disallow credits and request the Tax Department to recapture credits, only the Tax Department can actually perform the recapture. Therefore, this is an issue for the Tax Department. However, the Council has been advised in the past that while amending a tax return is limited to a three-year statute of limitations, Section 5930h allows for a recapture to occur for a much longer period.

The report confuses the two separate recapture provisions contained in statute and implies that they have been in place since 1998. As amended in 2003, the EATI statute requires that annual performance expectations be met during the (up to) five-year authorization period. The company must generate enough activity during that five-year period to earn credits and offset the income tax that the State will forego when the credits are applied. The performance is checked annually when the company files a tax return and an Annual Activity Report (VSA 32, Sections 5930a(k), (l), and (m)). After the "authorization period," the only performance that is monitored is the company's employment level, which must be maintained at 75% of the highest level reached during the authorization period (VSA 32, Section 5930(h)). Since a recapture of this sort can be triggered for up to six years beyond the last year a credit can be earned, the statute provides the authority to do so for that period.

The flow of information between VEPC and the Tax Department has improved measurably since the last report. The report confuses the lack of information from companies in their Annual Activity Report with the flow of information between the two agencies. Many of the examples of information voids cited in report have to do with changes in the program. As the program has been amended, so have the requirements of information from participants. Neither the administrators nor the companies could have foreseen the need to provide certain information before it was required by statute. For example, the change to statute in 2003 changed how the recapture for a "substantial reduction in employment" was to be calculated. The new calculation required capturing data on a company's annual average full-time employment. Prior to that change, the employment level required was the full-time employment at the end of the year (calendar or fiscal). These are different levels of employment used for different reasons. The report leaves the impression that the newly required information should have been collected all along.

VEPC does agree with the report regarding the way employment levels are requested on the program tax schedules that are filed with a tax return. It is confusing and redundant since that information is also requested on the Annual Activity Report. If the schedule asks for the information one way and the Annual Activity Report asks it another, the taxpayer is confused and may provide conflicting data. VEPC and the Tax Department will continue to improve the way information is requested in the Annual Activity Report and on the program tax schedules.

RECOMMENDATION 2

The Tax Department is now provided with all the information required to determine if investments meet required performance levels. This information is provided in the Performance Expectation Document, the company's tax return, the program tax schedules and the Annual Activity Reports.

The Tax Department has always had the authority to verify investments and had access to "all records and information necessary" to determine compliance in accordance with the statute in effect. The Legislature has stated no requirement, "guidance," direction or intimation that annual performance expectation benchmarks were to be provided retroactively for authorizations made before the requirement was enacted in July 2003. VEPC has complied with the requirement to provide Performance Expectation Document's with annual performance benchmarks since the passage of the amendment.

The report is confusing the disallowance/recapture that can occur because of non-performance during a five-year authorization period and the recapture due to significant job losses, which can occur after the authorization period. The report does not recognize that credits earned by several companies have been disallowed and recaptured in accordance with statute. VEPC and the Tax Department are proceeding with many other disallowance and recapture procedures in accordance with statute.

(AUDITOR COMMENT: Every EATI award is conditioned upon performance. However, the Tax Department and VEPC have not succeeded in structuring a system of performance verification as required by statute. This failure by Tax and VEPC to communicate and devise a system of verification is illustrated by their recent responses to this finding.

VEPC noted in its response to the Draft Report on December 23, 2004:

> ***"The program relies on the Tax Department to do their part to determine if the activity actually occurred and at what level before the credits are allowed and applied. They had the ability and the authority to verify investments and determine performance before the addition of annual benchmarks in 2003. They had to utilize other information, which was available to them. They are now provided with annual performance benchmarks."***

The Tax department noted in its response to the Draft Report on December 23, 2004:

> ***"The Council has declined to set such benchmarks. The Council has noted "VEPC does not agree with the Auditor's position that Tax credit authorizations approved prior to the change in statute should be reauthorized using the standard put in place by the change in the statute. The Department is no longer pursuing the matter."***

This circular shifting of responsibility has led to a program where no agency is conducting meaningful performance verification. The result is that millions of dollars in tax credits have been taken by companies who have not created promised jobs and economic activity.)

FINDING 3

This Finding speaks only of fiscal costs without mentioning the benefits derived from investments in Vermont that would not have been made 'but for' the incentives. Based on data received through the end of 2002, companies that have received authorization of EATI credits have made investments of over $430 million in Vermont. The program had a net positive revenue impact of over $9 million. That is $9 million in new revenues to the state that would not have occurred unless the incentives were offered.

The Legislature and the Governor understand that the other revenues generated by the economic activity, all of which occurs because of the incentive, offset the foregone income tax or education tax revenue. For this reason, the program was enacted in the first place. It is also why the program, which is still relatively new, requires legislative attention and amendment as the program matures.

The reasons used in this finding to justify a cap are hollow arguments:

- The legislature has an annual opportunity to

review the costs and benefits and effectiveness of the program regardless of a cap. Determining "alternative spending for purposes of economic development" incorrectly assumes the program incurs a cost rather than generates net revenues.

- Manufacturers may experience cyclical periods of higher demand during economic upswings, but this program is not limited to manufacturers and the program provides an incentive so that companies generate economic activity ***beyond*** that which would occur during those cyclical periods.

- The Council is well aware that the State's financial resources are limited. The Council is not determining if a company is in need of financial assistance. That is left to programs such as VEDA and CDBG. The Council is determining if a project would or would not occur without an incentive, whether the economic activity projected by an applicant is beyond what would have occurred anyway and will generate more revenue for the State than the income tax or education tax forgone, and to what degree a project and applicant meet a set of guidelines.

The program relies on the Tax Department to do their part to determine if the activity actually occurred and at what level before the credits are allowed and applied. They had the ability and authority to verify investments and determine performance before the addition of annual benchmarks in 2003. They had to utilize other information, which was available to them. They now are provided with annual performance benchmarks.

The Council objects to the characterization of the 'but for' being applied "superficially." The 'but for' is the most subjective part of the approval process, but can be and is being applied earnestly and in accordance to law by the Council members. (See more on this issue in the response to Finding 4).

The controls placed on the program by the legislature through the 'but for' test, the guidelines, the cost-benefit model, and the caps on net negative projects provide the necessary fiscal protection. These controls are superior to the alternative of "gross" program caps, which would restrict the program and result in the denial of excellent projects once the cap is met. It could also result in a 'first-in, first-out' effect where relatively inferior projects could be approved because they came in before the cap was reached.

(AUDITOR COMMENT: There are many ways to structure a program cap that would allow annual flexibility in project review and subsidy disbursement. Like any other State-funded entity, VEPC would have a designated spending authority, as authorized by the legislature in the annual budget process.)

RECOMMENDATION 3

The Council believes that this finding and recommendation fall outside the purview of this audit. As stated in statute and in the Purpose Statement of this audit, the audit is conducted to determine compliance with statute and to review the design and implementation of internal controls of the program. This finding and recommendation takes a position on policy contained in statute rather than compliance with the statute.

The Council opposes the imposition of "gross" program caps. Capping the program would be disastrous for economic development during a time when the state needs every tool for job creation. Imposition of a cap would increase the likelihood of awards having a net revenue cost to the state because all authorizations would be made without a determination of the activity being incremental and the cap would inevitably be fully utilized. Essentially, enacting recommendations 3 and 4 would transform the program to be more like the reward programs offered in other states for ***any*** economic activity rather than the incentive program that it provides for businesses to create economic activity that would not occur without the incentive. Further, a cap would mean that even excellent projects are randomly denied if they apply after the cap has been met or relatively inferior projects might be approved if they apply before the cap is met.

FINDING 4

The Council disagrees with the contention that the 'but for' is not being properly verified and disagrees with the absolute manner with which the issue is treated in this Finding and Recommendation. Administering the 'but for' is sometimes difficult,

but not impossible. The Council points out that even the report Finding fluctuates between the absolute statement that the 'but for' cannot be verified and the statement that the 'but for' is "entirely validated by the subjective judgment of the Council," which is the actual standard set in statute.

As required by law, the Council takes the 'but for" test very seriously and goes to great lengths to verify the veracity of official statements made by company executives during Council interviews with applicants. The judgment is not entirely subjective as suggested by the Finding. The Council utilizes all of the data and information submitted by the applicant in their deliberation of the 'but for'. Further, as with application data and information, the 'but for' statement is certified by requiring the signature of the applicant, thereby binding the official to that statement by law. The Council is not aware of any other programs that impose a falsification risk beyond self-incrimination for the applicant. Indeed, it is hard to imagine a standard beyond self-incrimination that would be more effective. The risk of perjury is substantial.

The 'but for' test is designed to allow the Council to determine whether or not the overall direct activity to be undertaken on the part of the applicant is in fact incremental to the Vermont economy. While it cannot be guaranteed that the Council's determination in this regard will be infallible, the Council has a track record of diligence on this issue. In addition, it should be pointed out that the background growth rates in the fiscal cost-benefit model that are applied in each application analysis are designed to help provide a fiscal safeguard against any incorrect determinations in this regard. The theoretical amount of credits authorized for an applicant is calculated only against the activity that would not have occurred without the incentive. The activity that did not generate a credit is the background growth, or the economic activity that would have occurred anyway.

The Council has worked very hard to implement a very subjective test with almost no guidance in statute. The Council believes it has developed methods through the application and interview process to accurately gauge a company's compliance with the but for "to the best of its judgment," as required by law.

The Council, businesses, economic development professionals, the Administration, and the Legislature recognize that many factors are taken into consideration when a company is reviewing expansion or relocation plans. Workforce, transportation and telecommunications infrastructure, quality of life, tax structure, etc. are all considered by applicants. Ultimately the decision to move forward depends on the issues impacting a company's bottom line, of which the potential of tax incentives are a critical factor. Most state tax incentive programs are not structured like Vermont's. The EATI program is very unique because of the strict cost-benefit modeling, the quality control guidelines, and the 'but for' test. Eliminating the 'but for' would make the Vermont program more like those in other states whose role are minimized in the academic literature cited by the report.

The Finding discussion includes much "evidence" that is irrelevant and spurious. The notion that two companies (out of over 200) have 'but for' statements that are similar shows only that the two companies faced similar situations when applying to the program. Since the program is only effective for companies that are contemplating some activity that is incremental to the State and beyond their normal (or background) growth, it is not at all unusual that their statements regarding that activity are similar.

Inclusion of the quotation from Richard Cowart is another example of either misunderstanding of the EATI program or the inclusion of misleading information. We do not know the context of the quotation, so it may also be that it is utilized out of context by the report. The quotation appears to apply to situations where a company is seeking a benefit for not leaving or somehow reducing electric load. That is not the case with the EATI program as it is structured in statute. It cannot act as a retention tool unless the Council decides to authorize credits that will result in a negative revenue impact for the State, which is very rarely done. The question being considered by the Council is whether a company will generate activity in Vermont that is beyond what would occur here without the incentive. Companies are not "threatening" to leave or expand somewhere else. They are weighing the costs and benefits of moving or expanding here versus somewhere else or doing so in a significantly different manner.

The financial need issue included in the report again highlights an exception and calls it the rule. Very few 'but for' arguments are made based on financial need. For those that are, we require information to support the claim and the Council members question the applicants carefully. The report goes on to imply that the Council should require detailed financial information from S Corporation owners that apply to the program. The discussion implies that many of these individuals have substantial income and the Council should determine if these individual need "supplemental assistance from the State" or should be able to proceed on their own. This is another example of misunderstanding of the intention of this program. First, if that were the standard being considered by the Council, it would also have to be applied to C Corporations. Second, these individuals are the current and future entrepreneurs of our State. They are deciding whether or not to move a business here, start a business here, or invest their income in expanding a business here. Finally, this is not the issue the Council members are determining. The 'but for' question is not whether the applicants can afford to do what they are projecting, it is whether what they are projecting would occur without the incentive.

The finding includes four "reasons" that are supposed to give the impression that the 'but for' is decided in an atmosphere that "strongly favors the applicants." These arguments are riddled with supposition and innuendo as evidenced by the use of words such as "appeared to," and "perhaps."

The report includes here another example of a misstatement that gives the impression that the Council is doing something wrong. The 'but for' question is ***discussed,*** not decided in closed session. All applications are voted on in public session. The Council is required by law to discuss the 'but for' and other application issues in closed or executive session because proprietary business information is discussed. The report gives the impression that the Council is acting inappropriately when deliberating in closed session.

Even though the audit team did attend a few meetings this year, there is no way they can fully judge the intentions of the voting Council members and the level of attention they give each application. The Council members study applications and staff summaries; they listen to every word spoken by the applicants and ask relevant questions. The report utilizes what might be one exception to generalize about the 'but for' consideration of all applications.

The discussion states the obvious regarding the fact that decisions are made from a "frame of reference." We all operate from a frame of reference in everything we do every day. The report correctly states that all current board members are business owners or business managers. The report fails to mention in this section that the Governor, in accordance with statute, appoints all the Council members. Both Governor Dean and Governor Douglas have appointed current members. The statute does not delineate the job or function an appointee must hold outside of their Council duties. It does state, "The Governor shall appoint citizens to the council who are knowledgeable and experienced in the subjects of community development and planning, education funding requirements, economic development, state fiscal affairs, property taxation, or entrepreneurial ventures." The appointments should also be geographically representational. The appointed members of the Council take their responsibilities to the statute and the taxpayers very seriously. However, they also make decisions based on their knowledge and experience. Ultimately, it is the Governor who decides the makeup of the voting membership of the Council.

Generally, the Council knows how a company would proceed without the incentives. This is discussed with the applicant and is discussed by applicants in their application documents. One of the improvements made by VEPC to the application requirements is for the applicant to include a detailed discussion of the activity that they are proposing because of the incentives. Further, the activity that would take place anyway, for the industry sector represented, is shown by the background growth calculated by the cost-benefit model.

The next portion of discussion in Finding 4 (number 4 in "Process favors applicants") is another example of supposition. It states that it is "unclear how well the Council appreciates that the fiscal benefits to the State are positive only if the Council determines the project would not happen without the incentives." First, this supposition only half states the 'but for,' which, in full states that the activity "would not occur

or ***would occur in a significantly different and significantly less desirable manner***," except for the incentive offered. (Emphasized portion is never mentioned by the report). Second, the conclusion requires the writer to "get into the minds" of the Council members. All Council members are acutely aware of the meaning and intent of the 'but for' and what it means to the fiscal impact of the application.

A footnote is included (#33 in the draft report) that emphasizes the provision in statute that includes, "the council shall apply a cost-benefit model to determine the return on investment to the state, relative to other applicants." (Emphasis added by report). The report suggests that the "Legislature envisioned competition between companies requesting State financial assistance." As previously discussed, this program is not providing financial assistance. This segment of the provision was included prior to the development of the cost-benefit model and the codification of the 'but for' in statute (Act 159, 2000). With these changes, it was no longer contemplated that there would be a competitive application process. Applicants are competing against the statutory elements of the program – the 'but for,' the cost-benefit results and the guidelines. This means that when there are no worthwhile projects, none are approved. When there are many, the Council can approve many. The Council could not conceivably respond in the statutory 45-day deadline, which is based on how quickly businesses need to make decisions, if they had to pool a meaningful number of applicants for a competitive round.

Inclusion in this Finding of statements made by recipients to the press over five years ago is not constructive. The Council took action against any companies that made statements contrary to their original 'but for' statement if the statements reported by the press were found to be true and accurate. One company lost their incentive authorization because of it.

(AUDITOR COMMENT: We agree with the Council that administering the "but for" test is "difficult." All statements of net fiscal benefit rely on the accuracy of the unverifiable "but for" test. This is not a reliable basis for fiscal cost measurement.)

RECOMMENDATION 4

The Council believes that this finding and recommendation fall outside the purview of this audit. As stated in statute and in the Purpose Statement of this audit, the audit is conducted to determine compliance with statute and to review the design and implementation of internal controls of the program. This finding and recommendation takes a position on policy contained in statute rather than compliance with the statute.

The 'but for' is the primary step to determine if the proposed activity represents incremental economic activity to the State. But it is not relied upon as the sole basis for asserting a theoretical positive return on investment. The cost-benefit model, based upon the data provided in each application, determines a positive or negative return. The Joint Fiscal Committee has approved the cost-benefit model. It is not the "VEPC model" as stated in the Finding. The Council believes that the 'but for' is difficult to administer, not impossible to administer. It also makes Vermont's incentive program unique in the country. Eliminating the 'but for' would change the program to be more like the reward programs offered in other states for any economic activity rather than the incentive program that it provides for businesses to create economic activity that would not occur without the incentive.

The current makeup of the Council complies with statute. Appointment to the voting membership of the Council is currently the prerogative of the Governor.

FINDING 5

This Finding broadly uses the term "property tax exemption" to apply to all the Education Tax-related incentives in the EATI program. This is misleading and represents a generalization about the program that is based on an exception rather than the rule. The report could lead the reader to believe that all the property tax incentives that are part of the EATI program exempt a company from paying their education taxes. In fact, the only incentive that exempts a company from the education tax liability for a limited time is the Construction-in-Progress Property Tax Exemption. Under this exemption, a company does not pay education taxes on a building that is being built until

it is 75% completed or occupied. The exemption is limited to two years. The other incentives either reduce the education tax paid on new liability due to an expansion or renovation (stabilization) or do not reduce the liability to the company at all (Allocations and TIFs).

The finding is also erroneous or misleading because:

- It again includes the incorrect assumption that all projected activity (incorrectly called "promised" in the report) must occur in order for revenues generated by the economic activity to outweigh the foregone education tax. Economic activity must occur at a level sufficient to generate the offsetting revenues, but that is not necessarily the same as the projected activity.
- The finding once again assumes that the requirement for annual performance expectation benchmarks was in place when these authorizations took place. In all cases, the authorizations occurred prior to that requirement.
- For most education tax-related incentives, the cost-benefit model assumed that the economic activity for these authorizations would occur over ten years, not the relatively short amount of time that has elapsed since they were approved.
- The report fails to recognize that two of the education tax incentives tied to the companies included in the sample group are for either education tax allocations or tax increment financing districts. These are incentives that benefit municipalities under which the companies involved pay the full amount of education tax. If the activity that was projected to generate the incremental education tax (e.g. construction of a new building) does not occur, then the incremental education tax is never generated and the allocation of the incremental education tax to pay for infrastructure never occurs. This is the action that would represent the cost side of the equation in the cost-benefit analysis.
- The report fails to recognize that all municipalities and the companies tied to the incentive authorized are providing Annual Activity Reports to VEPC as required by statute. These reports are reviewed annually and the information requested from municipalities and companies have been revised as the program is amended. Education Tax incentive authorizations have also been issued Performance Expectation Documents since that requirement was added by statute.

Since the previous report, VEPC staff and Tax Department Property Valuation Division have worked on detailed procedures for the administration of all education tax incentives. These procedures are being finalized and will be implemented as soon as all parties involved agree to the procedures. An issue that remains to be resolved is whether the Legislature contemplated recapture of foregone Education Tax revenue from municipalities and under what circumstances. The performance review procedures and recapture provisions in statute refer only to income tax returns. The Legislature may have recognized that the impact of these authorizations is different from income tax credits because a tax stabilization agreement, for example, has no effect unless a new property is built or major renovations are performed. If the jobs and other investments do not occur as projected, the municipality and Education Fund still benefit from the new property assessment after the stabilization ends.

The costs and benefits associated with TIF authorizations are calculated the same as any other incentive. The difficulty is that a TIF District might include economic activity that cannot be specifically identified by the applicant municipality. The application is based on projections just like other applications. However, the projections are more speculative because the applicant municipality might not know exactly which businesses will be locating within the TIF District and exactly what economic activity will occur.

However, the Finding is incorrect to state "There is no limit to the potential foregone state property tax revenue from such a district." The foregone revenue is limited by the amount of incremental education tax that can be generated by the economic activity that can possibly occur within the district. Also, the amount of forgone revenue is limited by the cost-benefit model, which limits the overall amount of cost (foregone revenue) in accordance to the amount of offsetting revenue (benefit) generated by the projected economic activity. That limit is included in the authorization. It is also self-limiting in the sense that incremental education tax revenue is only generated if capital

investments are made (i.e. buildings are built) and the incremental education revenue is only foregone if the infrastructure is built and the Education Tax revenue is utilized to pay for it.

The Legislature obviously was aware of this when it included TIF Districts in the EATI statute. VEPC recognized the need to monitor this level of uncertainty regarding the exact economic activity to occur and requires reviews of the TIF projects that have been authorized.

(AUDITOR COMMENT: Thanks to initial VEPC technical comments by Executive Director Fred Kenney, we have changed all mention of EATI "property tax exemptions" to "municipal awards."

That some municipal awards involve a redirection of property tax payments by the affected company to the municipality is not a relevant distinction affecting State fiscal costs. Such awards still represent a significant fiscal cost to the State Education Fund and are costs that are borne by other taxpayers.)

RECOMMENDATION 5

The Tax Department, Property Valuation Division and VEPC have developed draft detailed procedures for education tax-related incentives. The procedures are under review by the agencies involved (Tax, VEPC, Education, municipalities) and will be implemented when they are completely reviewed. The economic activity required to generate the revenues that offset the education taxes foregone under these authorizations generally takes place over ten year periods, not the short period examined by this report. However, reviews have occurred and several education tax-related incentives have been rescinded by VEPC.

The Council respectfully points out to the Legislature that the authorization to create Tax Increment Financing Districts is separate from the EATI statute and is a right given to municipalities by the Legislature (See VSA 24, Sections 1891 – 1900). VEPC is only involved if the municipality wants to request the utilization of the incremental education tax revenue generated within the District to help pay for the infrastructure debt incurred by the municipality to ensure the development of the District. If this ability is removed, municipalities lose a valuable tool to encourage economic development.

FINDING 6

This finding is surprising in the sense that the issue was never mentioned to VEPC by the audit team and that it is just incorrect. The cost-benefit model calculates background growth for all the credits by estimating the amount of activity that would occur within the region and sector that matches the applicants sector and region. This occurs for incremental payroll, research and development investments, capital investments, and workforce development investments. It is true that the only credit category that is actually calculated as a true increment is the Payroll Tax Credit. That credit is calculated by subtracting the previous year's payroll, and background growth, from the current year's payroll. The other credit categories are calculated by subtracting only background growth from the amount of investment in a given year. This is in accordance with statute.

There are no cases where an applicant was authorized for a credit that represented 100% of their investment in these areas. For example, a company authorized for credits may project that they will spend $400,000 on research and development in 2005. Simply illustrated, the cost-benefit model calculates the authorized credit as 10% X ($400,000 – background growth). The level of background growth varies for the type of company and the region in which they are located or to which they are locating. The result is the authorization of a credit that is less than the 10% of the actual investment.

(AUDITOR COMMENT: Companies with valid R&D awards currently are eligible for a 10% R&D tax credit whether or not their R&D investment in any given year meets projected levels or even exceeds levels in years prior to the VEPC award.)

It may be true that when the credits are actually allowed by the Department of Taxes, all of the investment made by the company in that year is multiplied by the rate for which the company is eligible, not authorized. VEPC has repeatedly tried to get the Department to utilize the authorized rates that have been adjusted by the cost-benefit model instead of the flat rates for every company. This has not occurred. However, the design of the Performance Expectation Documents with detailed annual

performance benchmarks have and will prevent this from occurring.

(AUDITOR COMMENT: This is yet another example of circular shifting of responsibility between VEPC and Tax. The Tax Department in its response agreed with the current audit finding.

VEPC, per the above, blames the Tax Department for improperly calculating relevant award rates.

This failure to establish proper controls has resulted in millions of dollars in improperly allowed tax credits and represents a significant portion of the $8 million dollars in awards that have been allowed to companies who have actually reduced employment.)

RECOMMENDATION 6

Option 1 offered by the report is a solution searching for a problem.

Option 2 offered by the report is the viable solution and has actually already been implemented as part of the Performance Expectation Documents containing specific annual performance benchmarks.

The cost-benefit model already calculates credits for only incremental investment expenditures.

FINDING 7

This section of the report includes another misrepresentation of the EATI program. The report intimates that a company can fully earn all credits within five years because of program procedures developed by VEPC. Actually, companies *must* earn all credits within five years in accordance with statute. VSA 32 Section 5930b states, “Approval…may be for up to five years.” The time period is correct, but it is because of statute, not VEPC’s procedures.

A seven-year period of projected activity is utilized in the cost-benefit model because it represents a normal business cycle (approximately 5.5 years), plus additional years to accommodate expected peaks and troughs in the economy. Just as it is logical that companies should not receive incentives for activity that is actually normal cyclical recovery, they should not be penalized for economic downturns. Utilizing seven years of projections allows a company to apply earned credits even if there is a bad year or two since normal business cycles include up periods and down periods.

When the program was conceived, the use of a seven-year period by other incentive programs was reviewed and found to function appropriately. Incorporation of the seven-year formula in the EATI program cost-benefit model was reviewed and approved by the Joint Fiscal Committee.

The Council appreciates the discussion regarding new applications from companies who had been authorized for credits in the past. The overlap of job growth and investment must be carefully monitored, properly modeled, and considered from the ‘but for’ perspective. During the period examined (through June 2004), only five of 214 applications were reapplications to the EATI program for a new project after the five-year authorization period had expired or after all activity projected in the first application had occurred. Therefore, this type of application should be viewed as an exception and not used to represent the whole program.

The few applications that fall into this category will be reviewed from the seven-year perspective to ensure that job creation and investment were not “double-incented.”

The Council agrees that the program should not provide incentives that merely support cyclical recovery. However, this finding is inaccurate. Guideline #1 already contemplates this situation by suggesting that employment levels should exceed the applicant’s average annual employment for the two preceding years. The program application requires inclusion of this data. Further, the cost-benefit model utilizes background growth rates based on historic data so that the credits calculated by the model are only applied to growth beyond the normal business cycle.

(AUDITOR COMMENT: We appreciate VEPC’s attention to this new issue and will look forward to a review of any corrective action taken.)

RECOMMENDATION 7

The Council already carefully considers employment and investment levels when considering applications from companies that have been authorized in the past. VEPC will review the few applications that fall into this category to ensure that employment and investments did not overlap.

The Council disagrees with the recommendation regarding cyclical recovery and believes the guidelines and cost-benefit model already include safeguards against issues raised regarding cyclical recovery activity and implementation of the program.

(AUDITOR COMMENT: Calculating fiscal costs and benefits over a 7-year period while allowing full award receipt after only five years of performance accomplishment is yet another reason even the theoretical net fiscal costs of this program are likely to be negative.)

FINDING 8

As required by law (VSA 32, section 5930a(d)), the Council applies the cost-benefit model in a uniform manner, including consideration of the passage of time and inflation on the value of multi-year fiscal benefits and costs. In fact, the credits resulting from each cost-benefit model run are always less than what an applicant is expecting because they are calculated to include background growth so the credits are calculated only on incremental investment.

Preliminary runs of the cost-benefit model are run occasionally. They are usually run because a company or economic development professional are comparing overall incentive packages and costs between two states. In other cases, the data may be discussed and revised if an inconsistency is found or data is missing.

Requiring the applicant to specify the authorization level expected or needed would weaken, rather than improve, the program. Businesses assess a number of criteria when making major investment decisions relative to future growth. The success of business expansion cannot be predicted by making specific calculations of each criterion as suggested by the report. To ask applicants to project "exactly how large a state subsidy is needed to incent a given investment" is impossible to do. It is not a specific "not to exceed amount" for each criteria used by business in it's decision process but rather a range of amounts for all criteria looked at in aggregate to reach major business conclusions.

(AUDITOR COMMENT: It is impossible to calculate the credits based on "incremental investment" only, for any individual company. The so-called "background growth rates" are broad discount factors based on long term growth rates, not company specific information. They provide a 5-10% discount in the award calculation, depending upon the industry and time period during which the model is run.

As noted previously, the Council typically permits an award recipient to perform within 10% of a stated performance expectation level and still receive the full award. This variance could completely negate any potential fiscal benefit from the background growth rate discount.)

RECOMMENDATION 8

VEPC staff makes every effort to obtain complete data to avoid multiple runs of the cost/benefit model. Preliminary runs of the cost-benefit model are done rarely. Requiring applicants to specify the credit amount needed would weaken the incentive program. Requiring businesses to be specific in a process that is based on multiple financial projections and other uncertain outcomes would be impossible. Since business cannot be specific, most applicants would shy away from such an incentive program in total and favor incentives requiring fewer specifics offered by other states.

FINDING AND RECOMMENDATION 9

This Finding and Recommendation do not involve VEPC.

FINDING 10

This Finding contains the most blatant assumptions in the report. The finding states, "It ***appears*** the [Annual Report to the General Assembly on the EATI program] ***may have*** assumed that if a company has been allowed an award it has met its performance expectations and therefore all promised economic activity has occurred." (Emphasis added). This assumption is totally unfounded. The 2004 Annual Report filed by VEPC and the Department of Taxes utilized actual activity data available at the time the report was compiled.

- The employment data reported in the Annual Report published in April 2004 on the EATI program was compiled using the employment figures provided by participating businesses available at the time the report was compiled.
- The investment data was compiled from spreadsheets provided by the Department of Taxes. This data is taken directly from the program tax schedules and represents the actual investments made (including payroll increments) that served as the basis for allowing a credit.
- Data was included only for companies that earned a credit. This is done so that the aggregated employment and investment data is for the same set of companies that earned credits and is for the same time period.
- The fiscal impact data was generated by applying the same cost-benefit analysis used for each application to the program, which has been approved by the Joint Fiscal Committee.

This Finding once again assumes that performance expectations existed for the period and authorizations examined by the report. They did not exist then.

(AUDITOR COMMENT: As noted previously, performance expectation documents were required as of July 1, 2000. Prior to that, every award was accompanied by a letter from the VEPC Executive Director stating that the awards were conditioned upon the projected performance. To state that there were no "performance expectations ... for the period ... examined by the report" is false.)

The discussion in the Finding regarding "theoretical economic and fiscal impacts" is incorrect. The first section of the Annual Report provides the application activity, the amount of incentives authorized, the amount of economic activity that could theoretically occur, and the theoretical fiscal impact of that activity. This data is not presented as "a yardstick of program performance" as stated by the report. It is included to show the authorization activity to date and the total theoretical activity and impact of that authorized activity. Nothing in the first section of the Annual Report refers to this as a statement of actual program performance. The second part of the Annual Report includes data that shows the actual program performance. All the information included in the Annual Report is required by statute.

The EATI Annual Report does not state that 100% of the projected activity would not occur without the incentives. Only the audit finding claims this. As discussed in the response to Finding 4, VEPC is well aware that humans cannot have perfect insight and the 'but for' is a subjective test.

Here again, the report makes a statement that is a supposition when it states, "an honest accounting of this program would probably recognize a substantial real net fiscal cost to the State. (Emphasis added). The Annual Report provided by VEPC and the Department of Taxes to the Legislature represents an estimate of the program impacts based on the data on hand at the time and utilizing the cost-benefit analysis approved by the Joint Fiscal Committee for this program. For the period represented, the data and analysis reflects a positive net revenue benefit of over $9 million for the State.

(AUDITOR COMMENT: This Annual Report to the Legislature leaves the reader with the mistaken impression that the program generates significant net fiscal benefits to the State. Conversely, this compliance audit demonstrates that 21 companies were allowed $20.9 million in tax credits, producing only 226 net new jobs or 6.5% of those promised.)

RECOMMENDATION 10

The Annual Report provided to the Legislature by VEPC and the Department of Taxes represents an estimate of the program impacts based on the data on hand at the time and utilizing the cost-benefit analysis approved by the Joint Fiscal Committee. The data was based on actual company investments as reported by the Department of Taxes and employment levels provided by the companies at the time the report was compiled. The report was in no way based on assumed investment or employment levels.

VEPC will continue to provide the information in the Annual Report as required by statute, including the theoretical economic and fiscal impact of authorized activity.

Response to the 2004 State Auditor's Review of the Economic Advancement Tax Incentive Program by the Vermont Economic Progress Council

Appendix A

Chronology of Events Regarding The Provision of Performance Expectation Documents For Tax Credit Authorizations Under The Economic Advancement Tax Incentive Program

March 11, 1998: Act 71 enacted: Contains new EATI program in Section 48. Act does not mention any performance measures to be included in notification of approval. In fact, Act did not even include the requirement for a notification of approval. Tax credit authorization letters issued by VEPC stated, "in order to claim the credit(s) (company) will have to actually perform and make investments as noted in the application." As noted by the 2002 audit, the Council has also made statements such as "companies cannot claim tax credits until after the investments have been made and verified by the Tax Department" and "The incentive program has been set up so that companies can claim credits only after investments have been made and verified by the Tax Department." These statements are all true and consistent. But none of them state that companies are expected to make investments that exactly match the projections in their applications. "Performance-based" was interpreted to mean that the company had to perform at some level in order to earn the credits and would only earn them as investments were made and verified. An authorization of credits was not equal to an automatic reduction in income tax liability, as it is in some other state tax credit programs. It was assumed that tax would examine each return to verify an investment was made, ensure the investment was appropriate and consistent with the application and apply the credit consistent with the amount of investment made. Once the total eligible investment was reached, the maximum credit amount authorized was reached, or the authorization period ended, no further credit would be allowed. These indicators were, and are, issued by VEPC on Certificates of Eligibility for each credit, which the tax department receives.

Note also that the legislature authorized a position and funding for a new position at the Tax Department to undertake the examination of returns under this program.

May 29, 2000: Act 159 enacted. Section 10 requires VEPC to provide a written notification to applicant (with copy to tax) that, among other things, "shall specify performance expectations on which continuing approval shall be conditioned." Act also required Annual Activity Reports. VEPC authorization documents began including a "Performance Expectation Document" that included a "But For" Assessment, an assessment of the guidelines, and a paragraph of text regarding performance expectation for each incentive category. The text stated what was expected to be accomplished by the company by the end of the five-year authorization period. VEPC expected tax to use the five-year expectation as a goal against which the annual activity could be measured.

Further, Section 11 of Act 159 included the authorization for the Department of Taxes to access "all records and information necessary to determine whether an award recipient has complied with performance expectations in the written notice of approval."

June 6, 2000: Audit (Flanagan) of EATI program provides no oversight or comment on Tax Department verification of investments or compliance with performance expectations. No evidence exists to indicate that the Department of Taxes had started any verification or compliance examination, such as requesting clarification of

authorization documents, requesting copies of applications, or requesting clarification of, or more detailed, performance expectations.

February 4, 2003: Audit (Ready) of EATI program. Finding 1 of audit is critical of tax department verification and compliance procedures. The audit stated, "The Department of Taxes has always had broad statutory authority…to review all tax incentive credit claims by a taxpayer, and to determine whether credits were properly taken under the specific statutes creating the credit." It further stated, "Much of the information required under the new version of the statute – such as the detailed application made to the council – is easily obtainable by the Department..."

The recommendation accompanying this finding included the following:

The Department of Taxes should develop a strong system of internal controls and procedures, including a manual and web site information, to improve the way VEPC-awarded tax credit claims are filed and examined.

- *The Legislature should amend the EATI statute to clarify that the Department of Taxes should review the performance of all tax credit recipients, including those awarded their credits before July 1, 2000,* representing more than $64 million in credits, to assure that companies have created the jobs and made the economic investments promised in their application. (Emphasis added)
- The Legislature should consider a range of steps to initiate rapid review and verification of all promised economic performance, while keeping commitments to those companies with VEPC awards.

The emphasis is added to the second recommendation above to indicate a step the legislature DID NOT agree to take when changes were made to the program in 2003 (see below).

(AUDITOR COMMENT: Based on Tax Commissioner Mallary's letter of January 31, 2003, the legislature assumed it did not need to make statutory changes in order for the Tax Department and VEPC to effect a reasonable review of the performance of tax credit recipients who were awarded credits before July 1, 2000. Assuming the issue was resolved, neither the Auditor nor the Joint Fiscal Office recommended legislative action to reiterate this in statute.)

The 2002 audit (issued in February 2003) included a response from Commissioner of Taxes Mallory to the auditor in regards to Finding and Recommendation 1 that stated the Department will:

1. Request VEPC to provide it with very detailed performance expectations for all credits awarded by VEPC prior to 7/1/2000. These performance expectations, or benchmarks, which would be similar to the performance expectations the Council now specifies for awards authorized after June 2000 pursuant to 32 V.S.A. § 5930a(k), can be used by the Department to determine whether there is full or partial compliance with the expectations and to determine what portion, if any, of the approved credit should be allowed; and

2. Review future requests for the utilization of credits pursuant to these benchmarks and allow or deny credits on that basis.

Note that VEPC was not a party to this response, nor was VEPC consulted on the response. It just appeared as part of the final audit document.

July 1, 2003: Act 69 enacted. Section 12a states "the Council shall set out the performance expectations upon which an award is based in clear and quantifiable benchmarks, sufficient to enable the department of taxes…to determine whether performance expectations have been met." Council begins issuing authorization documents that include specific annual benchmarks for the Department to compare against returns and schedules for the EATI program. Note that Section 26 of the Act includes several exceptions to the July 1, 2003 enactment date, **NOT** including Section 12a. The legislature **DID NOT** follow the auditor's recommendation to require the reexamination of authorizations from before the change in statute, nor the provision of specific annual benchmarks for authorizations made before July 1, 2000. The statute only required the new, annual, specific benchmarks for authorizations going forward from July 1, 2003.

(AUDITOR COMMENT: As mentioned above, Tax Commissioner Mallary's letter was considered to have resolved this issue without further legislative intervention. The issue is not one of "reexamination of authorizations from before the change in statute" — authorizations for pre-July 2000 awards had not been examined at all because the Tax Department felt it did not have sufficient information with which to do so. In order for meaningful examination of these award claims, Tax required and requested additional information from VEPC. VEPC refused to provide this information, contending that "the information was available to the [Tax] Department in accordance with the statute in effect at the time." The net effect of this stalemate was to increase the cost of the program by allowing credits without any meaningful performance review whatsoever.)

June 18, 2004: Letter from George Phillips to Fred Kenney. Letter is follow-up to January 31, 2003 response from Tax Commissioner Mallory to the auditor. The letter states that the Performance Expectations now being issued in compliance with the July 1, 2003 change in statute provide the "clear and quantifiable benchmarks… the department needs." The letter also requests benchmark documents for pre- July 2000 authorizations.

September 14, 2004: Letter from Fred Kenney to Commissioner Pelham. The final part of that letter explains the Council's position on this issue, includes a summary of the statutory changes cited above and indicates that the information required was available to the Department in accordance to statute in effect at the time.

October 12, 2004: Letter from Commissioner Pelham to Fred Kenney. Letter explains why the Department needs further information to go back and examine returns for which credits have already been allowed. Letter states the "Department cannot conduct the ***additional*** review of these credits…" (Emphasis added).

October 28, 2004: Council discusses the Commissioner's response and decides that further communication is not required. Council has stated its position on the issue, which is summarized as follows:

- VEPC provided the information required by statute in place at the time for the Tax Department to verify investments and determine compliance;
- After examinations of returns by Tax began and verification started, Tax indicated more detailed information would be required to determine compliance. The statute was changed and VEPC began issuing the required information as part of the authorization process;
- Only the legislature can compel the application of a change in statute to situations that occurred prior to the change in statute through the retroactive enactment of the change in the enactment clause of a bill. The legislature chose not to do that in this case;
- The Tax Department has always had access to all the information required by statute to be generated and issued in order to perform the verification and compliance examination in accordance with the statute in effect at the time; and
- The Tax Department was also the only organization involved in this program that was authorized for a new position with an appropriation for that position specifically to administer this program.

(AUDITOR COMMENT: The chronology could be improved by adding other important milestones, including:

February 1998: The Joint Fiscal Office (JFO) prepares an analysis of the potential fiscal impacts of the proposed EATI program and assumes it is controlled by a total program cap of $3 million in FY99. All JFO fiscal estimates made prior to legislative approval of Act 71 assume this overall program cap. At later dates some legislators express surprise that there is no program cap controlling overall program expenditures.

September-October 1998: VEPC acquires pivotal legal opinion that projects that are determined to have no net fiscal impact by the cost-benefit model are not to be included in the statutory program cap despite the fact that there is no formal "but for" test in place.

Cost-benefit model completed and presented to the Joint Fiscal Committee. It is approved, but the need for independent program oversight is recognized and initiated.

February 19, 1999: *First JFO Legislative Oversight Report reiterates prior JFO assumptions regarding an overall program cap and recommends implementation of such a cap. Report emphasizes the critical "but for" assumption underlying all fiscal claims of net benefits and costs. Estimates program could ultimately represent a net annual fiscal cost to the State of as much as $7-$9 million per year due to the impossibility of verifying the "but for" assumption. Report identifies the preponderance of projects in Chittenden County and absence of projects in counties with the highest unemployment rates.*

September 3, 1999: *Second JFO Legislative Oversight Report emphasizes the absence of organized award follow-up policies and procedures and recommends immediate action to remedy this. All prior oversight report findings are reiterated with legislative recommendations and options offered, including a recommendation that the State Auditor be charged with periodic review of the program and both JFO and Auditor's Office personnel be granted access to confidential program information for purposes of independent program review.)*

APPENDIX C:

EATI Statute

Vermont Statutes Annotated
Title 32
Ch. 151 Subchapter 11E.
Economic Advancement Tax Incentives

§5930a. Vermont Economic Progress Council

(a) There is created a Vermont economic progress council which shall be attached to the department of economic development for administrative support, including an executive director who shall be appointed by the council, knowledgeable in subject areas of the council's jurisdiction, and hold the status of an exempt state employee, and administrative staff employed in the state classified service. The council shall consist of nine citizens of the state appointed by the governor. The governor shall appoint citizens to the council who are knowledgeable and experienced in the subjects of community development and planning, education funding requirements, economic development, state fiscal affairs, property taxation, or entrepreneurial ventures, and shall make appointments to the council insofar as possible as to provide representation to the various geographical areas of the state and municipalities of various sizes. Members of the council shall serve initial staggered terms with three members serving three-year terms, three members serving two-year terms, and three members serving one-year terms. All council members' terms shall be three-year terms upon the expiration of their initial terms and council members may be reappointed to serve successive terms. The governor shall select a chair from among the council's members. In addition to the nine members appointed by the governor, there shall also be two regional members from each region of the state; one shall be designated by the regional development corporation of the region and one shall be designated by the regional planning commission of the region. Regional members shall be nonvoting members and shall serve during consideration by the council of applications from their respective regions. For attendance at meetings and for other official duties all appointed members shall be entitled to compensation for services and reimbursement of expenses as provided in section 1010 of this title. A regional member who does not otherwise receive compensation and reimbursement for expenses from his or her regional development or planning organization shall also be entitled to compensation and reimbursement of expenses for attendance at meetings and for other official duties as provided in section 1010 of this title.

(b) The Vermont economic progress council, within 45 days of receipt of a complete application, shall approve or deny the following economic incentives

(1) tax stabilization agreements and exemptions under subdivision 5404a (a)(2) of this title;

(2) the economic advancement tax incentives set forth in section 5930b of this title, the high-tech growth incentives set out in section 5930k of this title, and the sustainable technology incentives set out in sections 5930w and 5930x of this title;

(3) sales and use tax exemptions provided in section 9741 of this title that require the approval of the Vermont economic progress council;

(4) property tax exemptions that require the approval of the Vermont economic progress council under subdivision 5404a(c)(1) of this title; and

(5) applications for allocation to municipalities of a portion of education grand list value and municipal liability from new economic development under subsections 5404a(e) and (f) of this title.

(c) The council shall first review each application under subsection (b) of this section and ascertain, to the best of its judgment, that but for the economic incentive to be offered, the proposed economic development would not occur or would occur in a significantly different and significantly less desirable manner. Applications that do not meet the "but for" test are not eligible for economic incentives, and shall not be considered further by the council. If the "but for" test is answered in the affirmative, then prior to approving any application for an economic incentive under subsection (b) of this section, the council shall evaluate the overall consistency of each application with the following guidelines:

(1) The enterprise should create new, full-time jobs to be filled by individuals who are Vermont residents. The new jobs shall not include jobs or employees transferred from an existing business in the state, or replacements for vacant or terminated positions in the applicant's business. The new jobs include those that exceed the applicant's average annual employment level in Vermont during the two preceding fiscal years. The enterprise should provide opportunities that increase income, reduce unemployment, and reduce facility vacancy rates. Preference should be given to projects that enhance economic activity in areas of the state with the highest levels of unemployment and the lowest levels of economic activity.

(2) The new jobs should make a net positive contribution to employment in the area, and meet or exceed the prevailing compensation level, including wages and benefits, for the particular employment sector. The new jobs should offer opportunities for advancement and professional growth consistent with the employment sector.

(3) The enterprise should create positive fiscal impacts on the state, the host municipality, and the region as projected by the cost-benefit model applied by the council under subsection (d) of this section.

(4) The enterprise should be welcomed by the host municipality, and should conform to all appropriate town and regional plans and to all permit and approval requirements.

(5) The enterprise should protect or improve Vermont's natural, historical, and cultural resources, and enhance Vermont's historic settlement patterns.

(6) It is desirable for the enterprise to make use of Vermont resources.

(7) It is desirable for the enterprise to strengthen the quality of life in the host municipality, and to foster cooperation within the region.

(8) It is desirable for the enterprise to use existing infrastructure or to locate in an existing downtown redevelopment project.

(9) If the enterprise proposes to expand within a limited local market, then the enterprise should not be given an unfair competitive advantage over other Vermont businesses in the same or similar line of business and in the same limited local market as a result of the economic incentive granted.

(d) In reviewing the application of a business or municipality under subdivision (c)(3) of this section to determine whether the applicant is eligible for the economic incentives under subsection (b) of this section, the council shall apply a cost-benefit model to determine the return on investment to the state, relative to other applicants, and to assist in establishing appropriate award levels for individual applicants. The cost-benefit model shall be a uniform and comprehensive methodology for assessing and measuring the projected net fiscal benefit to the state of proposed economic development activities. Any modification of the cost-benefit model shall be subject to the approval of the joint fiscal committee. The council shall perform

cost-benefit analysis in consultation with the commissioner of economic development. The cost-benefit analysis may include consideration of the effect of the passage of time and inflation on the value of multi-year fiscal benefits and costs.

(1) In determining the projected net fiscal benefit or cost of the incentives considered under subdivisions (b)(1), (4), and (5) of this section, the council shall calculate the net present value of the enhanced or forgone statewide education tax revenues, reflecting both direct and indirect economic activity. If the council approves an incentive pursuant to this section, the fiscal costs, if any, to the state shall be counted as if all those costs occurred in the year in which the council first approved the incentive and that cost shall reduce the amount of the annual authorization for such approvals established by the legislature for the applicable fiscal year.

(2) In determining the projected net fiscal benefit or cost of theincentives considered under subdivisions (b)(2) and (3) of this section, the council shall calculate the net present value of the enhanced or forgone state tax revenues attributable to the incentives, reflecting both direct and indirect economic activity. If the council approves an incentive, the fiscal costs, if any, to the state shall be counted as if all of those costs occurred in the year in which the council first approved the incentive and that cost shall reduce the amount of the council's annual authorization for approval of economic incentives as established by the legislature for the applicable fiscal year.

(e) A business or municipality may apply to the economic progress council to receive the economic incentives available under subsection (b) of this section, except that only a municipality may apply for approval of a tax stabilization agreement as allowed under subdivision 5404a(a)(2) of this title, education fund revenue sharing under subsection 5404a(e) of this title, and tax increment financing districts under subsection 5404a(f) of this title.

(f) The economic progress council shall have the authority to adopt rules under chapter 25 of Title 3 to provide streamlined and efficient procedures for processing and deciding applications.

(g) Decisions of the economic progress council shall be administrative decisions that are not subject to the contested case hearing requirements of chapter 25 of Title 3. The council's decisions shall be final and not subject to judicial review.

(h) Information and materials submitted by a business concerning its income taxes and other confidential financial information shall not be subject to public disclosure under the state's public records law in Title 1, chapter 5, but shall be available to the joint fiscal office or its agent upon authorization of the joint fiscal committee or a standing committee of the general assembly, and shall also be available to the auditor of accounts in connection with the performance of duties under section 163 of this title; provided, however, that the joint fiscal office or its agent, and the auditor of accounts, shall not disclose, directly or indirectly, to any person any proprietary business information or any information which would identify a business except in accordance with a judicial order or as otherwise specifically provided by law. Nothing in this subsection shall be construed to prohibit the publication of statistical information, rulings, determinations, reports, opinions, policies, or other information so long as the data is disclosed in a form that cannot identify or be associated with a particular business.

(i) The governor shall recommend to the general assembly, and the general assembly shall thereafter establish by law,

(1) an annual authorization for the total net fiscal cost of incentives the council may approve in the authorized year under subdivisions (b)(1), (4), and (5) of this section for projects that are net negative under the cost-benefit model;

(2) an annual authorization for the total net fiscal cost of incentives the council may approve in the authorized year under subdivisions (b)(2) and (3) of this section for projects that are net negative under the cost-benefit model.

(j) By April 1 of each year, the council and the department of taxes shall file a joint report on economic advancement tax incentives with the chairs of the house committee on ways and means, the house committee on commerce, the senate committee on finance, the senate committee on economic development, housing and general affairs, the house and senate committees on appropriations, and the joint fiscal committee of the general assembly and provide notice of the report to the members of those committees. The joint report shall contain the gross and net value of incentives granted pursuant to subdivisions (b)(1), (4), and (5) of this section and pursuant to subdivisions (b)(2) and (3) of this section during the preceding year. The joint report shall include an account of each incentive granted under subsection (b) of this section, from inception of the program to the date of the report, including the date and amount of the award, the expected calendar year or years in which the award will be exercised, whether the award is currently available, the date the award will expire, and the amount and date of all incentives exercised. The joint report shall also describe the extent to which the tax credits allowed by the department of taxes in the previous calendar year supported economic activity that complied with the performance expectations in the written notification of approval under subsection (k) of this section. The joint report shall summarize all credits awarded and earned, applied for, and carried forward by entities participating in the economic advancement tax incentives program authorized by this subchapter through the end of the preceding calendar year. The joint report shall include the claims by specific type of credit, number of participating entities, and tax type against which the credit is applied. The joint report shall also include information on award recaptures. The joint report shall also include information on economic activity, benefits to the state, and recipient performance in the fiscal year in which the credit was applied. The department of taxes shall develop the capacity to report by fiscal year the amount of total credits applied by tax type against the tax liabilities for the prior fiscal year and any award recaptures. The joint report shall also address the council's conformance with the annual authorizations established in subsection (i) of this section. The council and department may use measures to protect confidential financial information, such as reporting information in an aggregate form or masking the identity of the tax award recipient.

(k) The council shall provide written notification to the applicant of its approval of economic incentives under subsection (b) of this section. The written notification shall include both an assessment of the probability that the economic development activity would not occur or would occur in a significantly different and significantly less desirable manner but for the approval of incentives under this section, and an assessment of the application's consistency with the guidelines set forth in subsection (c) of this section. The written notification shall also specify performance expectations on which approval has been granted and continuing approval shall be conditioned. In the written notification, the council shall set out the performance expectations upon which an award is based in clear and quantifiable benchmarks, sufficient to enable the department of taxes, pursuant to subdivision (1)(B) of subsection (l) of this section, to determine whether performance expectations have been met. The council shall forward a copy of the written notification, including its assessment and the performance expectations, with the certificate of eligibility that it provides to the department of taxes.

(l)(1)(A) On or before the date, including the date of any extensions, that an award recipient is required to file its return under the provisions of sections 5861, 5862, 5914, or 5920 of this title, an award recipient shall file a report with the department of taxes and with the council for each tax year for which the award is authorized by the council. The report shall respond directly to the performance expectations in the written notification of approval issued under subsection (k) of this section, and shall include a description of the economic activity, including the total number of jobs created, the number of new jobs filled by Vermont residents, the wages for the new jobs, investments made according to the categories of incentives awarded, the nature and extent to which the economic activity was

consistent with the guidelines in subsection (c) of this section, and any other information required by the council or the department of taxes to assess the performance of the award recipient.

(B) The department of taxes shall compare the award recipient's report with the performance expectations in the written notification of approval. Upon determining that an award recipient has met all of the performance expectations the department of taxes shall allow the tax credit and shall provide the council with a report of the credit amount allowed and the basis for allowing the credit. If the department of taxes is unable to determine full compliance with the performance expectations, the department shall request that the council conduct a more detailed review. If the department requests the council to conduct a more detailed review, the council shall assess whether the taxpayer's actual performance meets the goals of the overall performance expectations and all factors upon which the authorization was originally based. The council shall conduct the review in a manner consistent with the original authorization, including examination of consistency with guidelines, and, if necessary, application of the cost-benefit model. At the conclusion of its review, the council shall submit a written report to the commissioner of taxes, setting out the factors and bases for the council's reassessment, if any, and recommending that the credit be approved, in full or in part, or disallowed. Upon receiving the council's reassessment and recommendation, the commissioner of taxes shall decide whether the credit shall be approved, in full or in part, or disallowed.

(C) In assessing the performance of an award recipient, the department of taxes shall have the authority to obtain from the council all records and information necessary to determine whether the award recipient has complied with the performance expectations in the written notice of approval.

(D) In any one year, an economic incentive awarded under subdivision (b)(2) of this section shall not be applied to reduce the award recipient's income tax liability by more than 80 percent of its income tax liability in that year.

(E) Nothing in this subsection shall preclude the department of taxes from adjusting the tax liability of any award recipient whose credit was incorrectly calculated.

(2) By December 31 of each year following the approval of an economic incentive, until the December 31 following the taxable year in which the approved incentive expires, an award recipient that has obtained the council's approval under subdivisions (b)(1), (4), or (5) of this section shall file a report with the council, stating the amount of any incentives used during the preceding taxable year, and detailing compliance with all performance expectations upon which the award was conditioned.

(m)(1) Recapture for failure to meet performance expectations. The value of any economic incentives taken by an applicant that has obtained the council's approval under this section shall be refunded to the state, and any economic incentives remaining to be exercised shall be disallowed in the event that:

(A) the applicant fails to comply with all performance expectations upon which the award was conditioned as set out in the notification provided in subsection (k) of this section and determined by the department of taxes under subsection (l) of this section;

(B) the applicant knowingly fails to supply any information required under this section or knowingly files false or misleading information; or

(C) the applicant fails to file the report required in subsection (l) of this section.

(2) The commissioner may assess amounts payable under this subsection any time within the time period provided in section 5882 of this title for adjustments to the returns on which the credit is applied or within three years of the date that the required report or information was due or the false or misleading information was supplied. The award recipient shall pay the amount required by this subsection within 30 days of the commissioner's assessment.

(3) the applicant fails to file the report required in subsection (l) of this section. (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998; amended 1999, No. 159 (Adj. Sess.), § 4, eff. May 29, 2000; No. 159 (Adj. Sess.), §§ 5-12; 2003, No. 67, §§ 8-14.)

§ 5930b. Economic advancement tax incentives

A business may request approval of not more than three of the five economic incentives provided in sections 5930c, 5930d, 5930e, 5930f, and 5930g of this title. A high-tech business may, in the alternative, request approval of not more than three of the five economic incentives as provided in section 5930k of this title. A sustainable technology business may, in the alternative, request approval of the sustainable technology research and development tax credit in section 5930w of this title in lieu of the research and development tax credit in section 5930d of this title, or request approval of the sustainable technology export tax credit in section 5930x in lieu of the export tax credit in section 5930f of this title. Approval of the Vermont economic progress council pursuant to this subchapter may be for up to five years. (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998; amended 2001, No. 138 (Adj. Sess.), § 3, eff. June 21, 2002; 2003, No. 67, § 15.)

§ 5930c. Economic advancement payroll tax credit

A person, upon obtaining the approval of the Vermont economic progress council pursuant to section 5930a of this title, may receive a credit against income tax liability imposed under this chapter equal to a percentage of its increased payroll costs, defined as salaries and wages, excluding any payroll costs attributed to an employee with more than 10 percent ownership interest including attribution of ownership interests of the employee's spouse, parents, spouse's parents, siblings, and children, within the state of Vermont in the tax year for which the credit is claimed above its costs of salaries and wages from the preceding tax year according to the following schedule:

(1) A person reporting less than $10 million in annual sales in the tax year that the credit is claimed may receive a credit against its income tax liability equal to ten percent of its increased costs of salaries and wages costs in the applicable tax year.

(2) A person that reports annual sales of $10 million or more, but less than $20 million, in the tax year that the credit is claimed may receive a credit against its income tax liability of six to nine percent of its increased costs of salaries and wages in the applicable tax year based on the following proportional, graduated scale:

(A) a nine percent tax credit for reported sales of $10 million through $12,500,000.00;

(B) an eight percent tax credit for reported sales of more than $12,500,000.00 through $15 million;

(C) a seven percent tax credit for reported sales of more than $15 million through $17,500,000.00; and

(D) a six percent tax credit for reported sales of more than $17,500,000.00 through $20 million.

(3) A person reporting more than $20 million in annual sales in the tax year that the credit is claimed may receive a credit against its income tax equal to five percent of its increased costs of salaries and wages in the applicable tax year.

(4) For a person in its first year of operation, its costs of salaries and wages in the preceding tax year shall be deemed to have been zero. (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998; amended 2003, No. 67, § 16.)

§ 5930d. Economic advancement research and development tax credit

(a) A person, upon obtaining the approval of the Vermont economic progress council pursuant to section 5930a of this title, may receive a credit against its income tax liability imposed by this chapter in the amount of ten percent of qualified research and development expenditures undertaken within the state of Vermont in the tax year for which the credit is claimed.

(b) "Qualified research and development expenditures" shall have the same meaning as provided for the term "qualified research expenses" included in the Internal Revenue Code at 26 U.S.C. § 41(b). (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998.)

§ 5930e. Workforce development incentive tax credit

(a) A person, upon obtaining the approval of the Vermont economic progress council pursuant to section 5930a of this title, may receive a credit against its income tax imposed by this chapter in the amount of 20 percent of its qualified training, education and workforce development expenditures within the state of Vermont in the tax year that such expenditures were made.

(b) Qualified training, education and workforce development expenditures under this section shall mean:

(1) expenditures eligible for financial assistance under the Vermont training programs administered by the department of economic development;

(2) expenditures defined in subdivision 127(c)(1) of Title 26 of the United States Code concerning the employee educational assistance initiative; or

(3) expenditures for employer-provided child care and transportation subsidies that allow for training and educational activities.

(c) A person that has obtained the approval of the Vermont economic progress council, may receive a credit against its income tax imposed by this chapter in the amount of 25 percent of its qualified training, education and workforce development expenditures for the benefit of individuals receiving public assistance who are participants in "reach-up" or other programs designed to help them achieve economic self-sufficiency. (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998; amended 2003, No. 67, § 18.)

§ 5930f. Vermont export tax incentive

A person doing business in Vermont and one or more other states, upon obtaining the approval of the Vermont economic progress council pursuant to section 5930a of this title, may receive a credit against its income taxes imposed by this chapter.

(1) For a C corporation, the credit is in an amount equal to the difference between a calculation of its income tax under the formula for apportionment provided in section 5833 of this title and a calculation of its income tax under the formula for apportionment provided in section 5833, except that such calculation shall be determined (i) without regard to that portion of subdivision 5833(a)(3) which provides that sales of property shipped from this state are sales of tangible personal property made in this state; and (ii) by double-weighting the sales factor in subdivision 5833(a)(3).

(2) For persons other than C corporations, the credit is equal to the difference between the amount computed by applying the corporate income tax rates provided in section 5832 of this chapter to the income attributable to Vermont determined using the two apportionment methods set out in subdivision (1) of this section as if the income attributable to Vermont were taxed at the entity level. (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998; amended 1999, No. 49, § 72, eff. June 2, 1999; 2001, No. 138 (Adj. Sess.), § 6, eff. June 21, 2002; 2003, No. 67, § 19.)

§ 5930g. Capital investment tax credit

A person, upon obtaining the approval of the Vermont economic progress council under section 5930a of this title, may receive a credit against its income taxes imposed by this chapter in an amount equal to five to ten percent of its total investments within the state of Vermont in plants or facilities and machinery and equipment in the applicable tax year, but only if those investments exceed $150,000, according to the following:

(1) A person employing fewer than 150 full-time employees that has obtained the approval of the Vermont economic progress council may receive an income tax credit equal to ten percent of its

investments in plants or facilities and machinery and equipment in the applicable tax year.

(2) A person employing between 150 and 250 full-time employees that has obtained the approval of the Vermont economic progress council may receive an income tax credit of six to nine percent of its investments in plants or facilities and machinery and equipment in the applicable tax year based on the following proportional sliding scale:

(A) a nine percent tax credit for 150-174 full-time employees;

(B) a eight percent tax credit for 175-199 full-time employees;

(C) a seven percent tax credit for 200-224 full-time employees: and

(D) a six percent tax credit for 225-250 full-time employees.

(3) A person employing more than 250 full-time employees that has obtained the approval of the Vermont economic progress council may receive an income tax credit equal to five percent of its investments in plants or facilities and machinery and equipment in the applicable tax year.

(4) A person is not required to acquire an ownership interest with its investment to be eligible to receive an income tax credit under this section, provided the Vermont economic progress council has approved a long-term capital lease as an investment eligible to receive an income tax credit, and the person's investment has been made in the form of a long-term capital lease that meets the lease accounting criteria established by Financial Accounting Standard No. 13 as promulgated by the Financial Accounting Standards Board. The person's investment shall be the present value, at the time the lease is executed, of the minimum lease payments over the period of the lease, excluding executory costs, as outlined in the Financial Accounting Standard No. 13. (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998; amended 1999, No. 159 (Adj. Sess.), § 13, eff. May 29, 2000; 2001, No. 138 (Adj. Sess.), § 7, eff. June 21, 2002; 2003, No. 67, § 20.)

§ 5930h. Carry-forward, carry-back, and recapture for substantial curtailment of trade or business

(a) Carry-forward. A credit not otherwise useable in the year earned may be carried forward to any subsequent year for which an approval exists, or to any of the next five succeeding years following the last year of the term approved by the council for the receipt of incentives.

(b) Carry-back. Carry-backs are not allowed for the economic incentives under this subchapter.

(c) Recapture amounts.

(1) In the event that a person has substantially curtailed its trade or business, then for any such year and all succeeding years, any unused economic incentives, including any amount of economic incentive carried forward, shall be disallowed, and any economic incentives used shall be recaptured in an amount equal to a percentage of the total economic incentive used, computed in accordance with the following table:

Years between close of tax year when economic incentive was earned and year when business became ineligible	Percent of economic incentives recaptured
Two or less	100%
More than 2, up to 4	50%
More than 4, up to 6	25%

(2) The recapture shall be reported on the income tax return of the taxpayer claiming the incentive for the tax year in which the 120 consecutive-day threshold occurred.

(d) Curtailment of trade or business. A person who has obtained an economic incentive under this subchapter shall file with the council and the commissioner of taxes each year until the sixth year following the last year for which an incentive was authorized a statement of the average number of full-time employees during that year and the lowest number of full-time employees for any 120-consecutive-day period ending during

that year. For the purposes of this section, "full-time employee" means an employee who works no less than 37 hours each week. A person shall be deemed to have substantially curtailed its trade or business if the average number of full-time employees in any period of 120 consecutive days is less than 75 percent of the highest average number of full-time employees for any year in a period of six years after the initial authorization of an incentive by the council.

(e) Notifications; hearing; written determination. A person that has obtained an economic incentive shall notify the council in writing within 60 days of a substantial curtailment of its trade or business. The council shall notify the commissioner of taxes of a substantial curtailment of trade or business and the amount of economic incentive authorized to the person required to report under this subsection. The council shall provide the taxpayer and the commissioner of taxes with a written determination of the amount of the economic incentive that shall be recaptured or disallowed as computed according to the table in subdivision (c)(1) of this section.

(f) Deferral and mitigation of disallowance and recapture. Within 90 days of receipt of written determination of recapture or disallowance under subsection (e) of this section, a person may apply to the council for a deferral of the disallowance or recapture for a nonrenewable period of 12 months.

(1) The deferral may be granted by the council upon its determination that there is a reasonable likelihood that the trade or business will restore its employment level above the minimum recapture level within the deferral period.

(2) Mitigation of disallowance or recapture may be granted or denied by the council in accordance with the following:

(A) If the taxpayer restores its employment level above the minimum recapture level, the council shall waive disallowance and recapture.

(B) If the taxpayer fails to restore its employment level to eliminate the substantial curtailment by the end of the deferral period and has failed to substantially complete all other goals upon which the incentive was based, any unused economic incentives shall be disallowed, and the amount of recapture shall be the amount as determined under subsection (c) of this section.

(C) If the taxpayer fails to restore its employment level to eliminate the substantial curtailment by the end of the deferral period but has substantially completed all other goals upon which the incentive was based, the council shall recalculate the costs and benefits of the taxpayer's actual job creation and performance related to the factors upon which the award was based. The council shall then determine and recommend to the commissioner of taxes a mitigated amount of disallowance or recapture based on the difference between the amount of credits already applied by the taxpayer and the amount of credits that is otherwise determined through the recalculation of the taxpayer's actual performance under the cost-benefit model. (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998; amended 1999, No. 159 (Adj. Sess.), § 14; 2003, No. 67, § 21.)

§ 5930i. Credit allocation

(a) Credit as calculated in this subchapter to a person who is a partnership, limited liability company, subchapter S corporation, or trust, shall be available to a partner, member, shareholder, or beneficiary required to pay Vermont income tax in the same proportion as the income of the person is allocated to the shareholder, partner, member or beneficiary.

(b) The amount of credit available to such partner, member, shareholder or beneficiary shall be no more than 80 percent of the person's precredit Vermont income tax attributable to the allocated income from the business eligible for the credit.

(c) Any credits available to a corporation pursuant to subsection 5930h(a) of this title shall be transferred to the shareholders of the corporation in the first year in which the corporation elects to file as an S corporation. The credits shall be available to the shareholders in the year of the election and shall be available for the same years as the credits would

have been available to the corporation. (Added 1997, No. 71 (Adj. Sess.), § 48, eff. March 11, 1998; amended 2003, No. 67, § 21a.)

§ 5930J. VERMONT ECONOMIC PROGRESS COUNCIL; LONG-TERM ECONOMIC DEVELOPMENT PLANNING

(a) The general assembly finds that long-term economic development planning is needed to build a diverse and sustainable economy, and to increase the well-being of Vermonters and their communities, without compromising the quality of our environment. This section is intended to enable Vermont to create and continually revise a long-term economic planning process. The general assembly further finds that the views of people from the public and the private sector, including Vermonters from business, education and government, are essential in order to develop a process for long-range economic planning and job creation. The Vermont economic progress council will be a forum for government and the private sector to work together in the public interest to create economic development plans for a diverse, sustainable economy for Vermont.

(b) The economic progress council shall advise the governor and the general assembly on long-term economic development planning.

(1) In fulfilling its economic development planning responsibilities, the council may:

(A) solicit the assistance of individuals and groups with interests or expertise in the particular subject before the council;

(B) request the assistance and cooperation of any state or local agency or governmental unit in collecting economic development information and conducting economic development planning. Such state and local agencies and governmental units shall provide reasonable assistance to, and cooperate with the council in the discharge of its responsibilities. The council shall consult and cooperate with the telecommunications technology council of Vermont, and any other council or committee established by law or executive action relating to economic development;

(C) appoint one or more task forces, composed of individuals from the public and private sectors, to assist the council in its economic development planning;

(D) perform such other activities as are necessary to carry out the purposes of this chapter;

(E) subject to the provisions of section 5 of this title, accept grants, gifts, donations or other things of value from a donor which is a qualified nonprofit organization under Section 501(c)(3) of the federal Internal Revenue Code for sums up to $200,000.00 to assist in defraying the costs of fulfilling the purposes of this chapter;

(F) execute contracts or provide grants, regarding professional or administrative services, to fulfill the purposes of this chapter;

(G) establish and administer a special fund, as provided under subchapter 5 of chapter 7 of this title, to be known as the Vermont economic progress council study fund for the purposes of fulfilling subdivisions (E) and (F) of this subdivision (1). Revenues to the fund shall be those funds collected pursuant to subdivision (E) of this subdivision (1); and

(H) before January 15 of each year, report to the general assembly the names of each donor and the amount donated under subdivision (E) of this subdivision (1), the names of the contractors and grantees and the amounts contracted for or granted under subdivision (F) of this subdivision (1), which list shall include the donations made during the fiscal year to date, as well as all donations made during the previous fiscal year.

(2) The council shall submit a biennial report to the governor and the general assembly on or before December 15, beginning in the year 2004, with its recommendations for implementing the state's long-term economic development planning agenda. Such recommendations shall contain goals, anticipated budgets, evaluation

mechanisms, and proposals for legislation where necessary. (Added 1997, No. 147 (Adj. Sess.), § 214; amended 2003, No. 67, § 22.)

§ 5930k. High-tech growth incentives

(a) For purposes of this section, "high-tech business" means a business whose activity in Vermont is certified by the commissioner of economic development to be exclusively in design, development, or manufacture of:

(1) Computer hardware or software, and information and communication technologies, such as high-level software languages, graphics hardware and software, speech and optical character recognition, high-volume information storage and retrieval, and data compression.

(2) Electronic devices involving microelectronics, semiconductors, electronic equipment and instrumentation; radio frequency, microwave and millimeter electronics; optical and optic-electrical devices; and data and digital communication and imaging devices.

(3) Medical devices, including medical, surgical or dental equipment, and excluding pharmaceutical products.

(4) Energy technology involving sources other than fossil fuels.

(5) Electric vehicles which draw propulsion energy only from an on-board source of electrical energy, alternative fuel vehicles, or hybrid vehicles which draw propulsion energy from both a consumable fuel and a rechargeable energy storage system.

(b) A high-tech business may request approval of not more than three of the following incentives provided in this chapter: sections 5930c (payroll tax), 5930d (research and development), 5930f (export incentive), 5930g (investment tax credit, but limited to investments in plants or facilities), and 5930k(c) (high-tech credit growth incentives).

(c) A high-tech business, upon obtaining the approval of the Vermont Economic Progress Council pursuant to section 5930a of this title, shall be entitled to the following set of tax benefits as one of its three incentives:

(1) **Machinery and equipment.** A credit of up to $100,000.00 per year against the income tax liability imposed under this chapter in an amount up to six percent (as determined under the cost-benefit analysis for the applicant) of its total investments within the state of Vermont during the period approved by the Vermont Economic Progress Council, in machinery and equipment, excluding expenditures for renovation of existing facilities to provide cable, fiber or telecommunications access.

(2) **Technology infrastructure.** A credit against the income tax liability imposed under this chapter in an amount up to six percent (as determined under the cost-benefit analysis for the applicant) of its total investments within the state of Vermont during the period approved by the Vermont Economic Progress Council, in renovation of existing facilities to provide cable, fiber or telecommunications access.

(3) **Workforce development.** A credit against the income tax liability imposed under this chapter in an amount equal to that allowed under section 5930e of this chapter, except that award of a credit under this subdivision shall not be limited to industrial manufacturing entities.

(4) Sales and use tax exemption for approved personal computers and software under subdivision 9741(47) of this title.

(d) Incentives under this section shall be subject to provisions of this subchapter, including authorization limits, reporting requirements, and application, cost-benefit analysis and approval requirements under section 5930a of this chapter. (Added 2001, No. 138 (Adj. Sess.), § 4, eff. June 21, 2002; amended 2003, No. 67, § 23.)

End of Subchapter 11E.

APPENDIX D

Audit Team

Susan R. Watson, CPA, Director of Statewide Audits during the audit period, was previously Finance Director at GPC International's U.S. Division in Boston, Massachusetts before joining the State Auditor's Office in 2001. She oversaw all the company's financial functions and controls, and led a team responsible for developing consolidated financial reporting software for the company's international network of divisions. As Director of Statewide Audits, she supervised and managed the federal Single Audit as well as the annual audit of Vermont's Basic Financial Statements, which includes significant testing of the State's internal controls and financial information systems. She is currently Director of Audit Compliance at the Treasurer's Office.

Thomas E. Kavet, President, Kavet, Rockler & Associates, of Williamstown, and Cambridge, Massachusetts, is consulting economist for the Vermont State Legislature, and has an extensive background in regional economics, public policy analysis, economic forecasting, and business economics. Since 1996, as economist to the Legislature, he has provided economic and tax revenue analysis and forecasts, research and analysis on tax issues and other public policies, and expert advice and testimony on a wide range of economic and policy issues. Previous to his establishing a consulting company in Vermont, he worked for 10 years as senior economist, director, general manager, and vice president at DRI/McGraw-Hill, Inc. (now Global Insight), the nation's largest economic consulting and forecasting firm, in New York City and Lexington, Massachusetts, where he initiated, developed and managed a wide range of economic research, forecasting and consulting services, including groups specializing in construction and real estate economics. Mr. Kavet worked as a consultant on the development of the EATI cost-benefit model in 1998 and has extensive professional experience with the REMI model upon which it is based. He has also performed three legislative oversight reports on the EATI program and participated in this Office's 2002 audit of the program.

George Thabault, Chief of Special Audits and Reviews, for the Office of the State Auditor, assisted the team with research, writing and audit planning and coordination. A former city councilor and assistant to the Mayor from Burlington, he has a background in public policy, municipal operations, research, and journalism. He joined the Auditor's Office in 2002 to coordinate a variety of non-financial-related audits and reviews, including recent reviews of nursing home licensing and regulation, the Weatherization Assistance Program, Department of Corrections selected contracts, and others.

Mitchell L. Pearl, is an Attorney with the firm of Langrock Sperry & Wool, of Middlebury. His practice focuses on a broad variety of litigation and commercial matters, land use and real estate issues, and civil rights cases. He is a graduate of Colgate University and New York University School of Law, where he was Managing Editor of the Law Review. He clerked for the Hon. Franklin S. Billings, Jr., Chief Judge, U.S. District Court, District of Vermont before entering private practice. He was awarded the David W. Curtis Civil Liberties Award in 1999 by the Vermont Chapter of the American Civil Liberties Union and is a member of the Vermont Supreme Court's Advisory Committee on Public Access to Court Records

APPENDIX E

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ATTORNEYS AT LAW

A Limited Liability Partnership
Including a Professional Corporation

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David W. M. Conard

REPLY TO:
Middlebury Office

December 15, 2004

Elizabeth Ready, State Auditor
Vermont State Auditor's Office
132 State Street
Montpelier, VT 05701

Dear Auditor Ready:

You asked this office for an opinion concerning the statute of limitations governing the Vermont Department of Taxes ability to review certain tax credits claimed under the Vermont Economic Advancement Tax Incentive ("EATI") Program. We understand that your office is in the process of performing a comprehensive audit of this program as required by 32 V.S.A. §163. We have previously reviewed the Tax Department's authority in connection with the program audit issued on February 4, 2003, and familiarity with our prior work on this matter is assumed. I also understand that the deadline to complete this audit is fast approaching, and accordingly I will omit any significant background materials.

QUESTION PRESENTED

The specific question presented is whether the three year general tax statute of limitations contained in 32 V.S.A. §5882 prevents the Tax Department from recapturing tax credits that may have been improperly claimed and allowed more than three years ago. The short answer is that this statute of limitations will prevent some enforcement, but not all enforcement.

DISCUSSION

The Vermont EATI Program and the statutes creating the Vermont Economic Progress Council ("VEPC") are complicated and contain a number of ambiguities. In part, these ambiguities stem from the fact that the statute was substantially revised during the 2000 legislative session, but not fully rewritten. The 2000 amendments (Act 159 of that year) did not contain clear guidance on

which portions of the new law would apply retroactively, nor on the method of reviewing and enforcing tax credit applications originally approved under the law before it was amended. The statute as it currently exists contains several different recapture and enforcement provisions. While these provisions overlap, the answer to the statute of limitations question depends on what type of recapture is being sought and under which statutory section. There are at least two circumstances under which the Tax Department has flexibility to seek recapture of credits previously claimed beyond the original three year period from the date of the return. Section 5930, the original manufacturer's investment tax credit provision, contains a specific recapture provision which is set forth in Section 5930(f). This provides as follows:

"In the event a manufacturer ceases to employ in Vermont, for a period in excess of 120 consecutive days, at least 50 percent of the number of employees it employed in Vermont as of January 1, 1993, then for any such year and for all succeeding years, carryforward of any unused credit shall be disallowed. Furthermore, there shall be imposed upon each such manufacturer a recapture penalty equal to a percentage of the total credit used . . . ."

32 V.S.A. §5930(f). The recapture penalty is computed in accordance with a table found in the statute. Under this section, the recapture must be reported on the taxpayer's income tax return **"for the year in which the 120 consecutive day threshold occurred." Id.** §5930(f)(1)(emphasis added.) Under the table provided in this section, the recapture can occur up to six years after the time the credit first became available. The section imposes an affirmative obligation on the taxpayer to report any necessary recapture. If it is not reported, or reported improperly or incompletely, the Tax Department would have authority to audit and potentially enforce such noncompliance. In such a case, the ordinary statute of limitations contained in Section 5882 ***would run from the date such recapture should have been reported*** on a tax return, not the date the credit was first taken.

Similarly, Section 5930h provides for recapture in the case of "substantial curtailment of trade or business." Such curtailment is defined in subsection 5930h(d) as employing in any 120 day consecutive period less than 75% of the highest average number of full-time employees at the time of the initial authorization of the tax incentive. Such "substantial curtailment of trade or business" will trigger a specified recapture percentage if it occurs any time within six years after the initial authorization. Again, the obligation is on the taxpayer to report any necessary recapture ***in the year that the recapture obligation occurs.*** Because this reporting obligation is mandated any time within six years of the initial authorization, a new three year statute of limitations will run from the time such report is (or should have) been made.

In contrast, Section 5930a(m) deals in general with recapture for failure to meet performance expectations. These performance expectations refer to the expectations set forth by VEPC in accordance with 5930a(k). This recapture provision requires that the applicant refund to the State the value of any economic incentives whenever the applicant "fails to comply with all performance expectations upon which the award was conditioned." 32 V.S.A. §5930a(m)(1)(A). Such performance expectations involve adding new jobs, making new investments, or other factors specified by VEPC in its written notification and certificate of eligibility provided to the applicant. This section specifically requires the Department of Taxes to assess any recapture within the time period provided by Section 5882 ***from the time that the tax credit was taken:***

> "The Commissioner may assess amounts payable under this subsection any time within the time period provided in Section 5882 of this title for adjustments ***to the returns on which the credit is applied*** . . . ." 32 V.S.A. §5930a(m)(2) (emphasis added).

This section appears to impose a limitation on the Tax Department's ability to audit for a general noncompliance with performance expectations to within the three year period following the filing of the return on which the credit is claimed.

CONCLUSION

Absent fraud of intentional misconduct,[1] the Tax Department will always be governed by Section 5882 — the three year statute of limitations period — but the date on which the statute first begins to run will vary based on the grounds sought for the recapture. Where recapture is simply for failure to comply with all performance expectations of the award, the three year statute will begin to run at the time the credit is taken on the taxpayer's return. However, in cases where there is a substantial curtailment of trade or business as defined in Section 5930h, or where in the case of a manufacturer's investment tax credit there is a reduction in employment that meets the provisions of 5930(f), the three year statute of limitations will not begin to run until the triggering event occurs. In other words, the three year statute of limitations will run from the date that the taxpayer should have reported the substantial curtailment of trade or business (or reduction in employment) on the taxpayer's return. This reporting requirement could occur, with varying recapture rates, any time within six years from the date of the credit.

Because the statute contains different recapture procedures for different events of recapture, it would be desirable for the legislature to clarify this in future legislation. Moreover, Section 5930a(m) may unnecessarily bind the hands of the Tax Department, given the complexities of the program and the difficulty for the Tax Department in determining whether the taxpayers' performance expectations have been met.

I hope this answers the questions you have presented. It has been a pleasure working with you and your staff. Should you need any further clarification or anything further, please do not hesitate to contact me.

Sincerely,

Mitchell L. Pearl

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MLP/jmp

316420.1

[1] And certain other exceptions set forth by statute.

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APPENDIX F

Selected Tax Department EATI Schedules

APPENDIX G

Applications to VEPC as of June 30, 2004