



Report of the Vermont State Auditor

December 29, 2006

**COMPLIANCE AUDIT:
ECONOMIC
ADVANCEMENT TAX
INCENTIVES
PROGRAM (EATI)**

**ADMINISTERED BY
THE VERMONT
DEPARTMENT OF TAXES
AND THE VERMONT
ECONOMIC PROGRESS
COUNCIL**

**Randolph D. Brock
Vermont State Auditor
Rpt. No. 06-05**

Mission Statement

The mission of the Auditor's Office is to be a catalyst for good government by promoting reliable and accurate financial reporting as well as promoting economy, efficiency, and effectiveness in state government.

This report is a work of the Office of the State Auditor, State of Vermont, and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from the State of Vermont or the Office of the State Auditor. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately. Please contact the Office of the State Auditor if you have questions about reproducing this report.

RANDOLPH D. BROCK
STATE AUDITOR



STATE OF VERMONT
OFFICE OF THE STATE AUDITOR

December 29, 2006

Speaker of the House of Representatives Gaye Symington
President Pro Tempore-elect of the Senate Peter Shumlin
Governor James Douglas
Mr. Michael Smith, Secretary of Administration
Mr. James Reardon, Commissioner of Finance and Management

Dear Colleagues:

I am pleased to submit the attached audit report as required by 32 V.S.A. §163(12)(A).

Based on our field work, examinations of records, interviews with staff at the agencies, and other research and analysis, it is our opinion that the Department of Taxes is in substantial compliance with requirements of the Economic Advancement Tax Incentives (EATI) program outlined in chapter 151, subchapter 11E of Title 32.

More specifically, the Department of Taxes has adopted and is carrying out new procedures to verify, before allowing a tax credit claim, that the required hiring, capital investments and other economic activity of an entity claiming the tax credit has been accomplished. This improvement addresses key findings from previous audits of the program by this Office.

The Vermont Economic Progress Council has adopted and is implementing new procedures to more carefully review those declarations and actions by entities applying for awards which address their required "but for" statement. The "but for" statement is signed by the entity's owner, president or chief executive and tells the Council specifically why, "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." Reviewing the "but for" statements in depth helps to reduce the risk of awarding tax credits for a project likely to occur anyway.

132 State Street • Montpelier, Vermont 05633-5101
Auditor: (802) 828-2281 • Toll-Free (in VT only): 1-877-290-1400 • Fax: (802) 828-2198
email: auditor@sao.state.vt.us • website: www.state.vt.us/sao

Weaknesses in the “but for” analysis were cited in previous audit reports. The recent improvements are, in part, reflective of a range of suggestions I provided to the Council Board members in January, 2006. There is still some subjectivity in the “but for” decision, but the new process provides the Council’s voting Board members with more data and opinion to help them assess, to the best of their judgment, whether or not a proposed project would likely occur without State tax incentives.

Despite progress in the review of “but for” statements, this report notes that the VEPC Board appears to have violated its own procedures in approving an improper amendment to an application, allowing a company to retain an award of more than \$600,000 in tax incentives. This report recommends that the Council rescind the amendment.

There is a provision in State law requiring EATI award recipients to notify VEPC within 60 days if they reduce full-time employment below a required, minimum number. We noted that none of 22 companies cited for possible recapture of tax credits due to a significant drop in employment met this requirement. After being notified of their situation, 17 of the companies requested a deferral or mitigation of the tax credit losses facing them, sometimes many months after the triggering event. A deferral allows a company time to restore the number of its full-time employees above the minimum number and thereby avoid recapture and disallowance.

We believe that an award recipient’s requirement to provide timely notice is mandatory under state law, and that failure to render a timely notice can lead to an unfair extension of the deferral time period, possibly favoring the award recipient at the State’s expense. Since the recapture of approximately \$1 million in tax credits from several firms has been deferred by VEPC, we are recommending that VEPC immediately review this situation to protect the State’s interest. (See page 23-24 for Recommendations.)

Based on these findings, it is our opinion that the Vermont Economic Progress Council is in partial compliance with the statutes, rules and regulations governing the EATI program at this time.

As you are aware, the Legislature in Act 184 of the 2005-2006 Session created the Vermont Employment Growth Incentive (VEGI) program to replace the EATI program on January 1, 2007. As of this date, the authority of VEPC to grant new EATI awards is terminated. However, the law states: “Any credits or incentives granted before January 1, 2007 shall remain in effect, including all carry-forwards, until used.”

There remains approximately \$45 million in awarded incentives that may potentially be earned within the next 5 years, some of which may be carried forward an additional 5 years. Thus, both the Tax Department and VEPC must continue to assess and document year-to-year performance of active entities. Continued vigilance is also required should a company fail to meet performance expectations or lower its full-time employment significantly. It is my hope that this audit report will contribute to the strengthening of important controls so that while the EATI program phases out, the State’s interests will continue to be safeguarded.

We would like to thank employees of the Tax Department and the Vermont Economic Progress Council for the assistance and professionalism they extended to us during this review.

Please feel free to contact me should you have any questions about this report.

Sincerely,

A handwritten signature in black ink, appearing to read "Randolph D. Brock". The signature is stylized with a large initial "R" and a long, sweeping underline.

Randolph D. Brock
Vermont State Auditor

cc: Mr. Thomas Pelham, Commissioner, Department of Taxes
Mr. Fred Kenney, Executive Director, Vermont Economic Progress Council

Contents

Report

Introduction	1
Highlights	3
Background	4
Scope and Methodology	7
Audit Results	10
Conclusions	22
Recommendations	23
Agency Comments and Our Evaluation	24
Appendix I: “But for” Application Requirements and Procedures	29
Appendix II: Comments from the Executive Director, Vermont Economic Progress Council	36
Appendix III: Comments from the Commissioner of Taxes	45

Tables

Table 1: EATI Program Authorizations October 1998 through July 2006	6
--	---

Figures

Figure 1: Example of Actual vs. Expected Timeline	19
---	----

Contents

Abbreviations

AAR	Annual Activity Report
EATI	Economic Advancement Tax Incentive
GFOA	Government Finance Officers Association
JFC	Joint Fiscal Committee
LLC	Limited Liability Corporation
PED	Performance Expectation Document
R&D	Research and Development
SAO	State Auditor's Office
VEGI	Vermont Economic Growth Incentive
VEPC	Vermont Economic Progress Council
V.S.A.	Vermont Statutes Annotated

Introduction

The concept of accountability for public resources is key in Vermont's governing process and an important element for a healthy democracy.

The requirement for the State Auditor to conduct a biennial compliance audit of the Economic Advancement Tax Incentives program was approved by the Legislature in Act 159 of its 2000 Session¹. The primary objective of this audit is basically twofold:

1. to examine if the Department of Taxes is verifying economic performance before allowing tax credits; and
2. to examine if the Vermont Economic Progress Council is complying with statutes regarding the "but for" statement, the additional reviews it conducts at the request of the Department of Taxes, and the recapture, deferral and mitigation process.

Government audits allow the public, legislators, and program managers to have confidence in the reported information on the results of programs or operations. They can also lead to improved program management, decision making, oversight and accountability.

Programs such as the economic advancement tax incentive often require periodic scrutiny because the costs of the program are not part of the State's normal budgeting process which involves presentation by the Governor, legislative review, debate, decision and ultimate approval of a specific annual appropriation by the Governor. The amount of EATI awards was not capped, but depended on the number of applications and the size of the development projects proposed. Annual awards ranged from a low of approximately \$5 million to a high of over \$44 million during the life of the program.

¹ In Act No. 184 of the 2005 Session, the Legislature terminated new EATI awards as of January 1, 2007, and required the State Auditor's Office to conduct biennial audits of the new Vermont Employment Growth Incentive Program (VEGI) that "shall include a comparative examination of the economic advancement tax incentive program and the Vermont employment growth incentives program with respect to performance measurements, program expenditure controls, the adequacy and availability of program information, and recommendations for improved accountability and fiscal controls. The auditor shall develop benchmarks, known as 'best management practices' that in the judgment of the auditor need to be met so that the Vermont employment growth incentives program may be administered in the most fiscally sound and well-managed manner."

Tax credits, when utilized by a taxpayer, lower State tax revenues. 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 expectations². This audit reports on several features of the program that, when functioning properly, reduce the risk of inappropriate awards and improper applications of tax credits by taxpayers.

² “Best Practices in Public Budgeting,” Government Finance Officers Association, 2000.

Highlights: Report of the Vermont State Auditor

Compliance Audit: Economic Advancement Tax Incentives Program (EATI)

(December 29, 2006, Rpt. No. 06-05)

Why We Did This Audit

This biennial audit is required by Title 32 V.S.A. §163(12)(A). Though new awards for the EATI program are not permitted after Jan. 1, 2007, there remains approximately \$45 million in awarded incentives that may be earned within the next 5 years, some of which may be carried forward an additional 5 years. Thus, both the Tax Department and VEPC must continue to assess and document year-to-year performance of active entities, and could benefit from this report.

What We Recommend

Among the recommendations in this report, we suggest that the Department of Taxes should follow statute requiring it to recapture utilized credits and to disallow any remaining credits when a company fails to comply with all its performance expectations.

We also recommend that VEPC's Board rescind an amendment to an approved application which permitted a substantially different project to receive an award in violation of VEPC policy.

VEPC should review all of the EATI deferral and mitigation decisions and consider whether the apparent lack of timely notice under 32 V.S.A. §5930h(e) might unfairly enlarge a deferral period to the detriment of the State.

Further, VEPC should adopt policies to ensure that companies failing to notify the Council within 60 days of dropping below their required minimum employment number will be ineligible to apply for deferral or mitigation.

VEPC should also clarify what background financial information is required from applicants, and what is considered optional.

Findings

The Vermont Economic Progress Council (VEPC) has implemented new procedures to improve its "but for" assessment. In the three "but for" applications we reviewed, the entities involved addressed the "but for" criteria, but did not provide some of the specific locational information requested by VEPC.

Further, after approving one company's application for tax credits related to creating new jobs and making investments in one location, the VEPC Board amended the application the next month in apparent violation of its own policies, allowing a substantially different project to be approved in an adjacent county without a new application as required under VEPC policy.

VEPC is in compliance with statutory provisions to notify the Joint Fiscal Committee (JFC) about modifications to the cost-benefit model, but has neglected its practice of providing an annual summary of minor updates to the JFC.

The Vermont Economic Progress Council is effectively administering the procedures in statute regarding recapture, deferral and mitigation.

However, VEPC did not adequately address potential impacts of companies failing to comply with a mandatory 60-day notification requirement regarding minimum employment numbers which may impact tax credit amounts to be recovered by the State.

The Department of Taxes (the Department) is verifying the economic performance of companies in the EATI program before allowing tax credits that the companies claim on their tax returns.

In one case we reviewed, the Department did not follow statute that would require the Department to recapture and disallow credits when the company clearly failed to comply with all performance expectations upon which the company's award was conditioned.

The Department is also properly allocating pass-through credits to individuals who are owners or members of a partnership, limited liability company, subchapter S corporation, or trust.

Background

The Economic Advancement Tax Incentives program was established by the 1998 Legislature in Act 71.

The program has offered a range of tax incentives designed to create quality jobs, close the gap between Vermont wages and the national average wage, and maintain and enhance the State's quality of life.

Based on an application process and utilizing the results of a cost-benefit computer analysis, the Vermont Economic Progress Council (VEPC), composed of nine individuals appointed by the Governor, has authorized tax incentives for businesses or municipalities in three broad categories:

1. Income tax credits based on payroll increases, research and development expenditures; workforce development expenditures; capital expenditures in facilities, machinery and equipment; and sales of product shipped outside the state.
2. Property tax reductions including stabilization agreements, construction-in-progress exemptions; brownfield redevelopment exemptions for businesses¹ and tax increment financing (TIF) districts; and education tax reallocations for municipalities.
3. Sales tax exemptions including exemptions for computers used in high-tech companies; for building materials in excess of \$250,000 used to build manufacturing facilities; and, until 1999, exemptions for certain equipment, fuel and electricity.

The Council reviewed applications based on several key considerations:

1. Whether, "but for" the incentive, the project would not occur, or would occur in a significantly different and less desirable manner;
2. The net fiscal impact of a project on Vermont's economy and state tax revenues, calculated through the measurement of the costs and revenues generated by the project; and

¹This exemption reduces the assessed value of a contaminated property or "brownfield," by the total amount of remediation and supporting infrastructure costs for a period of 10 years.

-
3. Whether or not the applicant and the proposed development adequately address nine guidelines in the law, relating to the quality of the new jobs to be created, the impact on the local community, the use of Vermont resources, etc.

The program was designed to be performance-based. The Department of Taxes is required to determine that the promised economic activities, upon which the award amount was based, have been achieved before allowing a credit to be applied to reduce a Vermont income tax liability.

Since July 2003, companies receiving an EATI award were provided a performance expectation document (PED) with annual performance benchmarks, such as adding a specific number of jobs, or making a certain dollar level of capital investments. Clear benchmarks assist the Department of Taxes in evaluating a company's performance when a credit is claimed.

If the Department of Taxes approves, or "allows" a tax credit claim on a given return, the entity (or pass-through shareholders) can apply the allowed credit amount against a maximum of 80 percent of that year's tax liability. Earned credits that are not applied can be carried forward for up to five years after the end of the authorization period. If a company subsequently reduces its employment to less than 75 percent of the highest average of full time employees for any year in a period of six years after the award,² the Department of Taxes may recapture all or a portion of previously applied credits and disallow unused incentives, including amounts carried forward.

From October 1998 through July 2006, the total amount of incentives authorized, for 190 applications, was approximately \$132 million. During the same period, approximately \$24 million of incentives related to 42 applications has been rescinded for a variety of reasons. Thus, the total amount of incentives made in the program was approximately \$108 million.

The Department of Taxes reports that approximately \$37.5 million in income tax credits has been earned in the program from inception through December 6, 2006. Approximately \$19 million has been applied to reduce tax income tax liabilities, and approximately \$15 million has been carried forward and could be applied against income tax liabilities in future years.³ Non-income

²Before July 1, 2003 the standard was 75 percent of the number of employees the company employed in Vermont as of the year in which a credit was received.

³Some of the earned credits have been recaptured or disallowed, thus the \$19 million and \$15 million amounts do not equal the total of \$37.5 million in credits earned.

tax credit incentives, such as awards which stabilize property tax rates for an entity, are not included in the amounts reported by the Department of Taxes as earned, applied, and carried forward.

The Department also reports that as of the beginning of 2006, about \$2 million in credits have been identified for recapture, and of that amount approximately \$870,000 has been collected as a result of recapture bills and legal settlements.

According to VEPC, approximately \$45 million in incentives remain available to be earned in years ahead by companies still within their authorization periods.

See Table I below for a summary of this information.

Table 1: EATI program authorizations, October 1998 through July 2006

GRAND TOTAL ALL APPLICATIONS CONSIDERED	\$153,421,718
OCTOBER 1998 - July, 2006	
LESS - TOTAL DENIED	\$5,230,027
LESS - TOTAL REPLACED	\$12,183,263
LESS- TOTAL REVOKED	\$3,514,611
Subtotal	\$20,927,901
EQUALS = TOTAL AUTHORIZED AS OF 7/31/2006	\$132,493,817
LESS- TOTAL RESCINDED AS OF 7/31/2006	<u>\$24,169,201</u>
EQUALS =TOTAL INCENTIVES AVAILABLE 10/1998 - 12/2015	\$108,324,616
(TOTAL COMPLETED INCENTIVES AS OF 7/31/06)	\$62,020,067
(TOTAL ACTIVE INCENTIVES AS OF 7/31/06)	\$46,304,549

Source: Vermont Economic Progress Council

More information on the program is available at www.thinkvermont.com/vepc.

Past SAO Audits Found Weaknesses in Program

The State Auditor's Office (SAO) has previously published audit reports on the EATI program.

In 2000, SAO published *State Auditor's Review of the Vermont Economic Progress Council's Implementation of Act 71 of 1998*, which found, among other issues, that the Vermont Economic Progress Council had failed to substantiate application data and "but for" attestations and had made tax credit awards to companies for economic activity that occurred prior to the company's application.

In 2003, SAO published *Promises to Keep: Recommendations to Strengthen the Performance of Vermont's Economic Advancement Tax Incentives Program*, which noted that the Department of Taxes had allowed tax credit claims without fully verifying that companies had created the jobs or made the capital investments they had initially projected.

In 2005, SAO published *Payoffs and Layoffs: the High Cost of Business Subsidies*, which found that some companies earned credits while failing to create promised jobs. This report also noted the complexity of the program and the time-consuming administrative demands it presented.

These reports are available on the State Auditor's web site:
www.state.vt.us/sao.⁴

Scope & Methodology

The scope of this audit included a review of compliance issues related to selected aspects of the Economic Advancement Tax Incentives (EATI) program established under chapter 151, subchapter 11E of Title 32, Vermont Statutes Annotated (V.S.A.). We reviewed actions taken primarily in calendar years 2005 and 2006. The scope of this audit was significantly narrower than past audits due to the fact that the EATI program will cease making awards as of January 1, 2007 and that during the planning process we noted that some past findings are no longer relevant or are being addressed.

⁴Not all of the audits were performed in accordance with Government Auditing Standards as issued by the Comptroller General of the United States, and as such this report does not rely on them. Reports conducted as "special reviews" meet different standards than those set out in Government Auditing Standards.

A compliance audit can be viewed as a type of performance audit as defined in Government Auditing Standards issued by the Comptroller General of the United States. In addition to assessing compliance with legal requirements, a performance audit may also “provide information to improve program operations and facilitate decision-making by parties with responsibility to oversee or initiate corrective action, and improve public accountability.”

We conducted interviews with officials at the Department of Taxes and VEPC, and the Council’s cost-benefit model subcontractors. We examined supporting documents including annual reports, correspondence, policies and procedures, checklists, and similar materials. We also consulted with the Attorney General’s Office.

Field Work at the Department of Taxes

To verify that the Department of Taxes had reviewed economic performance obligations before allowing tax credits, we reviewed the work of tax examiners in their processing of 10 tax returns from EATI awardees. Nine of 22 entities claiming tax credits in excess of \$10,000 in Tax Year 2004 were selected; one of two entities claiming tax credits in excess of \$10,000 in Tax Year 2005 was selected.

We reviewed the tax returns of the above 10 entities and also noted how the tax examiner in each case verified information on the tax return, such as capital investments, payroll totals, research and development expenditures, and other investments. We checked to see if performance expectations documents for each company were present in the entity folder; if new employment was verified, and what data sources were used for that verification; and if the employment recapture trigger number was current. We also checked the calculations of each tax credit claimed by the taxpayer.

Three of the 10 selected entities were organized as subchapter S corporations whereby tax credits earned by the entity are passed through to shareholders who may apply the credits on their personal income tax returns against income derived from the entity awarded the credits. We traced the allowed credits to the personal income tax returns of the shareholders and checked to see if the credits were allocated according to the correct ownership percentages and whether or not they exceeded the 80 percent maximum.

In the past two years, the Department of Taxes has conducted one field audit of an entity that had an EATI award. We reviewed this audit file to

determine if economic performance related to tax credit claims had been verified during the field audit.

Field Work at the Vermont Economic Progress Council

State law 32 V.S.A. §5930h describes the process used to recapture and disallow tax credits awarded to an entity that has suffered significant reductions in full-time employment. The statute defines these entities as those whose 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 VEPC.

VEPC reported 22 projects in the 32 V.S.A. §5930h recapture process as of July 31, 2006.

We selected five projects and reviewed the documentation related to each recapture process to verify VEPC compliance with a number of steps, including timely notifications by the entities; accurate calculation of the recapture amount by VEPC; timely application for deferral by the entity, if applicable; evidence of a reasonable likelihood of employment restoration; and other issues.

According to 32 V.S.A. §5930a(l)(1)(B), when the Department of Taxes is unable to determine a taxpayer's full compliance with the performance expectations (established as part of the original award) when reviewing a tax return, the department "shall request that the Council conduct a more detailed review." We selected five of the 53 requests on file at VEPC to review for compliance with the relevant guidelines in statute.

In January 2006 the Council adopted additional procedures in the review of an EATI applicant's "but for" statement. Three applications from 2006 were selected at random. Documentation was checked to verify that the Council and staff utilized the new procedures.

Government Audit Standards

We conducted this audit from October to December, 2006 in accordance with Generally Accepted Government Auditing Standards, issued by the Comptroller General of the United States.

Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the

evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Results

At the conclusion of field work, we sought clarification on several issues with staff at the Department of Taxes and the Vermont Economic Progress Council before compiling the audit results below.

Review of the Vermont Economic Progress Council's "But For" Procedures

VEPC adopted new required procedures in January, 2006 related to an applicant's "but for" statement and the steps that VEPC and staff would take to review and evaluate the statement. It should be noted that the "but for" test will be maintained in the State's new VEGI program that replaces the EATI program beginning January 1, 2007. (See Appendix I for the new policies and procedures.)

We selected three of 12 applications considered by VEPC in 2006 to determine how the applicant and staff complied with the new procedures.

Each applicant had signed "but for" statements in the file.

In each case, VEPC staff presented the "but for" statement and supporting documentation and information in a comprehensive write-up before the monthly meeting for Board members to use in judging whether or not the applicant would meet the "but for" test.

In each file we found the required Findings of Fact and Opinion regarding the company's "but for" claims, and each file contained confidential notes from the VEPC Board's executive session wherein the Board reviewed the "but for" case and questioned the company representative.

Applicants for tax incentives may claim they are considering locations and incentives out of state. To better understand the nature of these locational considerations, the new requirements state:

"If 'but for' is based on locational decision, [applicants are to] provide information, including contact information, on other locations and incentives offered."

We noted that each of the three applicants in their statements and presentations on their “but for” situation addressed key “but for” criteria in a direct manner. They discussed their consideration of out-of-state locations, mentioning items such as recruiting ability, tax rates and incentive programs available; however, none provided contact information, specific sites other than general areas such as a county, or specific incentives offered for their project. Without contact information supplied, it is difficult for VEPC staff to make follow-up inquiries to verify the status of any incentive offers from other locations.

In addition, the requirements state:

c. Optional documentation to be provided by applicant. The following should be provided by the applicant, if available. Certain documentation may be required, depending on the nature of the “but for” statement:

- i. Financial statements**
- ii. Business plan**
- iii. Equity/Financing Plan**
- iv. Market information**

None of the three applicants submitted financial statements, a business plan or a financing plan. We note that the instructions appear contradictory – i.e., the data is optional, but should be provided. All three did submit narrative comments regarding general market information.

The Board approved the “but for” statements for two applicants, and denied the third. Once a “but for” test is failed, the proposed project can no longer be considered for tax incentives. In the case of the denial, the Board felt there was not a compelling case to meet the “but for” criteria as established in statute and that the project would likely occur without the incentives. In the executive session Board members asked this applicant about sites, financing, and the need for incentives. In addition, the Board considered a letter from the Vermont town now host to the company which stated that local permits had been obtained for the expansion project and that the owners had already chosen to locate the expansion in that town.

Review of the Vermont Economic Progress Council's Approval of a Potentially Improper Amendment to an Application, Resulting in an Award of More than \$600,000 in Incentives

In reviewing the above three cases, we noted that one of the application approvals may have been improperly amended by the Council in the month following its initial approval.

The Council policy on amendments states:

Application Amendments: An approved applicant may request an amendment to an approved application for issues that do not substantially change the application. Any amendment must be consistent with the original “but for,” guidelines, and cost-benefit model. The amendment must be requested and justified in writing and be requested within the five-year period that commenced with the approval of the original application.

The applicant originally applied to expand at a leased facility and add workers in its current location. The application addressed this specific location and the Council's initial award was predicated on investments at the current location. However, a month after the award the company decided to purchase a facility in an adjacent Vermont county, instead of expanding at its leased facility, and notified VEPC of this decision.

VEPC staff and Board members noted that the planned changes would substantially change the application and thus could not be considered as an amendment; staff indicated a new application is typically required. In addition, we found no written request by the company for an amendment in the file, nor written justification by the company for amending the application.

At its next meeting, the VEPC Board approved substantial application changes at the request of VEPC staff reflecting the new project location and authorized over \$600,000 in tax incentives over five years. The notice to the applicant, and minutes of the meeting, indicate that the revisions were accomplished by amendment.

According to VEPC staff, the Board recognized that a new application would have difficulty passing the “but for” test, and that it approved the changes to

support a project that might not occur in a Vermont location without the previously awarded incentives.

The Board's action appears to violate its adopted policies regarding amendments to approved applications.

The Vermont Economic Progress Council and the Cost-Benefit Model

VEPC uses a cost-benefit model to determine the return on investment to the state and to help establish appropriate award levels for individual applicants.

The EATI statute requires that the Joint Fiscal Committee approve any modification of the model. VEPC provides the JFC with an annual memorandum that reports on the annual changes to the model that are typical routine updates of economic data used in the model. VEPC does not consider annual updates to be *modifications* of the model.

We reviewed documentation from the past two years. Updates and changes are summarized by the contractor and forwarded to VEPC annually in a memorandum. We noted that, though the changes were of an update nature only, VEPC staff did not submit the annual memorandum to the JFC in 2005 and 2006. Both were immediately sent to the JFC by VEPC as a result of our inquiry.

We noted that VEPC staff did submit proposed changes to the JFC related to the cost-benefit model related to the transition to the new VEGI program in November, 2006.

We also reviewed the issue of the retention of past versions of the cost-benefit model by the cost-benefit model contractor. Past versions of the model are critical because they must be used when VEPC recalculates the costs and benefits of a project based on actual performance.

Based on interviews and a visit to the contractor's office, we verified that past models and backups are available from 1998 to the present.

Review of the Vermont Economic Progress Council's Process for Performing "A More Detailed Review" of Tax Credit Claims Upon Request of the Department of Taxes

According to 32 V.S.A. §5930a(l)(1)(B), when the Department of Taxes is unable to determine a taxpayer's full compliance with the performance expectations when reviewing a tax return, the department "shall request that the Council conduct a more detailed review." We selected five of the 53 requests on file at VEPC to review for compliance with the relevant guidelines in statute.

We found in all five cases that VEPC reviewed actual performance of the company, and compared it with the performance expectations on file. In all cases VEPC sent an adequate report and recommendation to the Department of Taxes, and the Department of Taxes responded to the recommendations within three weeks or less.

We noted unusual factors with one case. The Department of Taxes found that a company did not meet its performance expectations for the 2003 tax year. The performance expectations described at the time of the award projected that the company would have 70 employees with a gross payroll of \$2.9 million the end of the year. The company reported 52 employees at \$1.9 million in gross payroll. The PED also projected \$9.3 million in sales for 2003 but reported sales of \$4.4 million.

The EATI statute notes that any applied credits will be recaptured and incentives remaining to be exercised shall be disallowed in the event that:

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. (§5930a(m)(1)(A)).

The Department of Taxes is of the opinion that subsection (L) referred to here only permits the Department to allow tax credits, and that the statute

does not permit the Department to deny a tax credit by determining that a company has not met all of its performance expectations.⁵

Based on this interpretation that it can only allow tax credits and not deny them, the Department referred the above company to VEPC for a more detailed review, even though the company's performance was quite short of the performance expectations it had agreed to meet.

VEPC's recommendation was to allow any previously earned credits to be applied because the company had added 28 new jobs and increased payroll by \$1 million. The Department of Taxes accepted this recommendation.

We believe the Department of Taxes in this matter should have complied with the EATI statute provision highlighted above to recapture applied credits and disallow unearned and carry forward credits for failure to meet all performance expectations for a given tax year.

The issue for this company was rendered moot in November 2006 when the company asked VEPC to remove it from the program because the proposed construction project did not materialize. Unearned credits are expected to be rescinded by VEPC; credits that have been applied or carried forward may be subject to recapture and disallowance depending on employment level, or the Department of Taxes could simply recapture and disallow the tax credits under the statutory provision highlighted above.

Review of the Vermont Economic Progress Council's Recapture, Deferral and Mitigation Process

VEPC reported 22 projects in the 32 V.S.A. §5930h recapture process as of July 31, 2006. This section of the EATI statute describes the process the State must take to identify and possibly recoup tax credits used by companies whose employment has fallen below a specific threshold.

⁵32 V.S.A. 5930a(1)(1)(B) states: "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." The Department of Taxes believes this statute does not permit the Department to deny tax credit claims.

We selected five projects and reviewed the documentation related to each recapture process to verify VEPC compliance with a number of steps, including timely notifications by the awardee; accurate calculation of the recapture amount by VEPC; timely application for deferral, if applicable; evidence of a reasonable likelihood of employment restoration; and other issues.

We noted that none of the five companies examined, having lowered their employment below their threshold number, reported a recapture on their tax return of that year, as required by §5930h(c)(2). Nor did any of the five notify VEPC in writing within 60 days of falling below the employment threshold, as required by §5930h(e).

Eventually, all five were notified by VEPC that a certain amount of tax credits that they had applied against tax liabilities might be recaptured, and other unearned and carried forward credits might be cancelled, or disallowed.

Four of the five applied to VEPC for a deferral of recapture and disallowance within the required time limit. The fifth company requested a deferral that was not considered because it was sent before the company received its notification of recapture. After VEPC sent the formal notice, the company did not follow up with a formal request for a deferral. In this case, the Department of Taxes is proceeding with recapture of applied credits and disallowance of unearned credits and those in carry forward status.

In the four deferral decisions, we found that the Council, as required, based its determination upon evidence that there was a likelihood that employment would be restored above the minimum level before it voted to approve a deferral.

We noted one minor irregularity in these specific cases. At the conclusion of a 12-month deferral a company is required to have restored its employment level *above* the minimum recapture level; if it achieves this mark, the Council shall waive the disallowance and recapture that is pending. In one case, the recapture level was 50, and to comply with the statute, the company should report employment at 51 full-time workers or higher. VEPC inadvertently communicated to the company that the goal was 50 full-time employees. At the conclusion of the deferral, the company reported 50 full-time employees and VEPC then waived disallowance and recapture of tax credits.

Another company did not restore employment to the minimum level, but was deemed to have substantially completed all other goals upon which the tax incentive award was based. In this situation, VEPC is charged with re-

calculating the costs and benefits of the taxpayer's actual job creation and performance using the cost-benefit model. We found no exceptions in this process, where the cost-benefit model showed that a maximum of \$82,500 in credits would have been earned by the company's actual performance. But because the company had applied more than that -- \$133,007 -- to reduce taxes during the award period, the difference of \$50,507 would be recaptured by the Department of Taxes.

Review of the Requirement for a Company to Notify VEPC Within 60 Days When It Has a "Substantial Curtailment" of Business

In reviewing documentation about entities in the recapture, deferral, and mitigation process outlined in 32 V.S.A. §5930h, we noted none of the 22 companies complied the provision requiring a company to notify VEPC within 60 days of the point at which it has reduced employment below a specific threshold point⁶ and thereby experiences a "substantial curtailment" of business.

After being notified by the Department of Taxes or VEPC about dropping below the employment threshold, or belatedly noticing the employment level and the notice requirement themselves, 17 of the affected companies requested, sometimes many months after the triggering event, a deferral or mitigation of the recapture and disallowances facing them,

We believe that the notification requirement is mandatory under State law, and that failure to provide timely notice under the provision, 32 V.S.A. §5930h(e), means that a company might unfairly extend a deferral period beyond what was contemplated by adhering to provisions in law. Briefly put, a company should not gain an advantage from violating a statute over those companies that might comply with the statute.

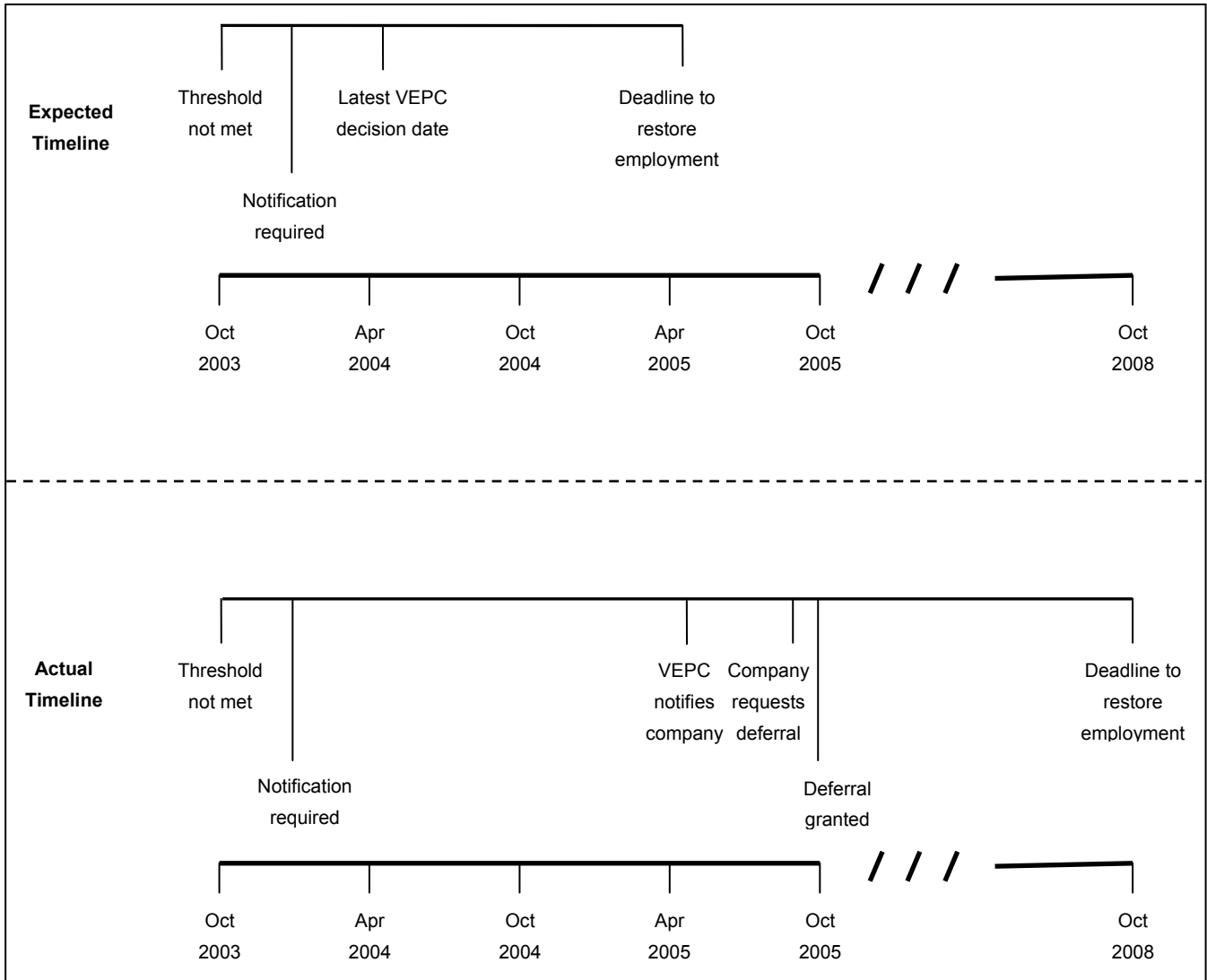
The following example illustrates the potential implications of failing to enforce the 60-day requirement notice.

Consider a company, "XYZ, Inc.," that was granted an EATI tax incentive award in 2000. The company earned and applied credits in the first few years of its 5-year award period, but then experienced setbacks in the marketplace. In October of 2003 the company's employment fell below the required

⁶The law states: *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.* (32 V.S.A. §5930h(d)).

minimum threshold for the 120th consecutive day. The 60-day notice requirement in statute thus expired in December of 2003. In May 2005, VEPC noted the company's employment situation. In August 2005, almost two years after the triggering event, VEPC sent the taxpayer a notice of possible recapture and disallowance of credits. The company requested a deferral in September 2005. The deferral request was for 36 months because the Legislature enacted legislation, effective as of July 1, 2005, that increased the nonrenewable deferral term from 12 to 36 months. This deferral was granted by VEPC in October 2005. Figure 1 illustrates the difference between the timeline of this example, versus the timeline that should have occurred had the 60-day notification period been properly recognized.

Figure 1: Example of Actual vs. Expected Timeline



Source: SAO analysis of example cited

Had the taxpayer complied with the law and notified VEPC by December 2003, a different timetable would have ensued. We estimate, in this example, that VEPC could have approved a 12-month nonrenewable deferral by April or May 2004 at the latest. Thus, the company would have had until April or May 2005 to restore employment, rather than the current deadline of October 2008.

By failing to report its reduced employment status in a timely manner, the EATI recipient in this example greatly increased the time available to restore employment and avoid recapture of utilized credits and the disallowance of other credits.

If a company does not reach the minimum full-time employment level by the end of the deferral period, the State is in a position to disallow unearned credits and those credits that have been carried forward, and to recapture a portion of the credits applied by the taxpayer.

If the company restores full-time employment to the required level by the end of the deferral period, the Council is required to waive the disallowance and recapture.

Thus, any improper extension of the deferral period allows a company more time to avoid losing credits that might otherwise be recovered under the correct notification timelines.

We believe it is inappropriate for a firm to benefit from violating the notification statute. Recapture of approximately \$1 million of tax credits is currently in deferral from four companies. In addition, two firms with \$379,126 of tax credits available for potential recapture had their recapture and disallowance of tax credits waived in 2006. For each of these entities, a recalculation of potential recapture amounts based on what would have been timely notifications of employment reductions could change the amount of credits that have been waived or that are available for recapture.

We also note that VEPC staff and Board members appear not to have raised questions or expressed concerns about the companies' non-compliance with the notification requirements and possible implications on deferral requests.

Review of Department of Taxes' Verification of Economic Performance Before Allowing Credits

To verify that the Department of Taxes had reviewed economic performance obligations before allowing tax credits, we reviewed the work of tax examiners on 10 randomly selected tax returns, as described in the field work above, previously submitted by EATI awardees and processed by the Department.

For nine tax returns, we noted no significant exceptions in the tax examiner's actions to verify economic performance before credits were allowed. The

documentation indicated that the Department verified economic activity by checking confirming data and information from several sources, including employment tax withholding records, previous tax returns, performance expectations documents (PEDs), and direct communication with the taxpayer.

Regarding one claim, we initially questioned the allowance of a research and development (R&D) tax credit of approximately \$358,000. In this case, the amount of R&D expenditures reported by the company in one section of its Annual Activity Report (AAR) was substantially lower (by 32 percent) than the expenditures reported on the tax return Schedule 5930D-B (0703); in another section of the report, the R&D total matched the tax return total. Further, though the company operates several facilities in other states, a check of the federal tax return (Form 6765 Credit for Increasing Research Activities, line 25, *Total qualified research expenses*) indicated that the Vermont R&D expenditures made up 86.1 percent of the firm's total R&D expenditures. The examiner noted that the Vermont site historically has high R&D expenses, and the payroll and capital investment data on the return and the AAR matched up well. However, the examiner agreed that the AAR/tax return discrepancy and the high percentage of Vermont-based R&D provided sufficient justification to request additional information from the taxpayer before allowing the credit. The examiner proceeded to make such a request and received supporting information from the company justifying the EATI R&D tax credit as claimed. Thus, of 10 claims examined, there were no exceptions.

A past audit by this Office found significant variances between credits earned and economic performance justifying those credits. Currently, we believe the Department of Taxes' efforts to review EATI credits today adequately ensures a proven link between credits earned and economic investments.

Review of the Department of Taxes' Allocation of Pass-Through Credits

Three of the entities reviewed were pass-through organizations (two subchapter S corporations and one limited liability corporation -- LLC) whereby credits earned by an entity through the achievement of required economic investments and the creation of new jobs are passed through to the entity's individual shareholders, as a percentage of their ownership, who may apply the credits against their personal income tax liability derived from the tax credit entity.

We reviewed the allocation of credits for the individuals involved and found no exceptions.

Review of the Department of Taxes' Field Audit of an EATI Award Recipient

During the past two years the Department of Taxes conducted one field audit of a company with an EATI credit award.

We reviewed the work papers of this field audit to see if the auditor verified that economic performance required for any credit claims had been achieved.

The particular company was flagged for an audit for reasons not related to the EATI program.

The field audit did not include examination of EATI credits and activities to justify past credit claims. However, the Department is in the process of recapturing applied EATI tax credits and disallowing other credits due to the company's failure to meet performance expectations and failure to file timely and complete reports.

Because the Department's review of EATI credits claimed on entity tax returns has improved, it may not be necessary for field auditors to conduct an in-depth review of EATI credit performance unless that action is supported by the Department's EATI examiner.

Conclusions

The Vermont Economic Progress Council has implemented new procedures to improve its "but for" assessment. In the three "but for" applications we reviewed, the entities involved addressed the "but for" criteria, but did not provide some of the specific locational information requested by VEPC. The requirements for applicants to submit financial information in addition to the application appear contradictory.

Further, after approving one company's application for new jobs and investments in one location, the VEPC Board amended the application the next month in apparent violation of its own policies, allowing a substantially different project to be approved in another Vermont location without a new application.

VEPC is in compliance with statutory provisions to notify the Joint Fiscal Committee about modifications to the cost-benefit model, but inadvertently neglected its practice of providing an annual summary of minor updates to the JFC.

The Vermont Economic Progress Council is effectively administering the procedures in statute regarding recapture, deferral and mitigation.

However, the Council and staff did not adequately address potential impacts of companies failing to comply with the mandatory 60-day notification requirement regarding minimum employment numbers. Late notification may allow companies to receive extended deferral periods from VEPC, with possible adverse financial consequences to the State.

VEPC is in partial compliance with the statutory requirements we reviewed.

The Department of Taxes is verifying the economic performance of companies in the EATI program before allowing tax credits being claimed on entity returns.

The Department is also properly allocating pass-through credits to individuals who are owners or members of a partnership, limited liability company, subchapter S corporation, or trust.

In one case we reviewed, the Department did not follow the statutory requirement to recapture and disallow credits when a company clearly failed to comply with all performance expectations upon which the company's award was conditioned.

The Department is in substantial compliance with the EATI statutory requirements we reviewed.

Recommendations

The Department of Taxes should request an opinion from the Attorney General to clarify its authority to recapture utilized credits and disallow unearned credits when an EATI awardee fails to comply with all performance expectations, as described in 32 V.S.A. §5930a(m)(1)(A).

The Vermont Economic Progress Council should rescind the amendment of a previously approved application that authorized a substantially different project and over \$600,000 of incentives in violation of VEPC policy.

The Vermont Economic Progress Council should adopt a policy whereby companies failing to notify the Council within 60 days of dropping below their required minimum employment number will be ineligible to subsequently apply for recapture deferral or mitigation.

VEPC should review all of the EATI deferral and mitigation decisions and consider whether the apparent lack of timely notice under 32 V.S.A. §5930h(e) might unfairly enlarge a deferral period to the detriment of the State. In consultation with the Attorney General's Office and the Department of Taxes, VEPC should, where feasible, recalculate all recapture and disallowance amounts based on timetables and statutes that would have been applicable had the companies notified VEPC of a "substantial curtailment" of business within the required time period.

Further, VEPC should adopt policies to ensure that companies failing to notify the Council within 60 days of dropping below their required minimum employment number will be ineligible to apply for recapture deferral or mitigation.

VEPC should clarify what background financial information is required with initial applications, and what financial submissions are considered optional.

Agency Comments and Our Evaluation

Vermont Economic Progress Council

The Vermont Economic Progress Council (VEPC) responded at length to the draft audit report regarding the Council's "but for" procedures. These are the Council's requirements and actions used to evaluate EATI applications and which will also be used in the new Vermont Economic Growth Incentive (VEGI) program which begins in January, 2007. (See Appendix I for the complete VEPC response to the draft report.)

VEPC's response notes that with new program literature, guidebook, and application forms developed for the VEGI program will demonstrate full implementation of the Council's improved "but for" procedures announced in January 2006.

The report noted that in the three applications we reviewed none of the companies submitted contact information on other locations and incentives offered by other governmental entities, even though the companies' "but for" statements were based on locational factors. VEPC agrees that contact information is required if relevant to the "but for" statement and review, but cautions that it should not be assumed that VEPC will verify applicant statements about specific incentives from other governmental entities in every case. The Council wrote, "The statute does not provide the Council the

authority to conduct investigations, nor is the Council provided sufficient resources to conduct investigations or verification of every fact presented in an application.” (Appendix I, p. 3.)

We would agree that VEPC may lack staff to undertake in-depth reviews of all applications, but we would also argue that the EATI statute does not prohibit staff from inquiring with other states or jurisdictions about whether or not incentives have been offered to any applicant. The Council members, as appointees of the Governor, are bound under the State’s Executive Code of Ethics to conduct business in “a manner as to instill public trust and confidence” and “every appointee shall be true and faithful to the State of Vermont ...” Since the EATI statute permits the Council to adopt rules for processing and deciding applications, it would appear that the Council has the ability to adopt procedures that might require staff, under certain circumstances, to make inquiries regarding attestations expressed in a “but for” statement.

VEPC’s response also notes that “the Council did not improperly amend an application,” as the report discusses on pages 12-14 of the draft report. The Council believes it adhered to its own policies, specifically Section 7(a)(2). (Appendix I, p. 3-4.) The response states, “The application in question fell into category 2 and the circumstance that changed was the location, within Vermont, of the project. New jobs and payroll would be created, but in a different location within Vermont. The incentives approved were based on those jobs and a certain level of capital investment in plant fit-up.”

We note that category 2 of the procedures cited by the Council relate to revised applications. The response faulted the audit report by not including reference to this section. However, we reviewed this section of the Council’s procedures, but believe it that it did not apply to the case we reviewed. In this case, the Council did not consider a revised application; it amended an approved application where the amendment substantially changed the application. The specific benefits of the project are not at issue. The Council’s policies are designed to protect the State’s interest. A minor change to an approved application can be approved by the Council’s voting members as an amendment. The Council’s procedures require that substantial changes to an approved application should be reviewed as part of a new application. A new application provides the Council with the opportunity to determine, to the best of its judgment, if the intended project is likely to occur without State incentives. Following Council procedure, we believe, would be in the State’s best interest. Therefore, after reviewing the Council’s response and our evidence, we respectfully stand by our recommendation that the Council rescind this amendment.

Regarding the cost-benefit model, VEPC's response notes that the Joint Fiscal Committee has been notified of all updates to the model and that approval has been sought from the Committee for all modifications to the model. These actions will continue under the new VEGI program beginning in 2007.

VEPC's response also notes the apparent weaknesses in the deferral and mitigation process regarding the matter of late notification of the "trigger event" whereby a company falls below a required minimum number of full-time employees. The Council notes that the reliance on self-reporting by businesses is difficult because many companies find it difficult to calculate a recapture amount, or are not fully aware about what level of employment triggers a recapture and requires notification.

We agree with the Council's comment that "the statute is silent on the potential consequences of a business not filing the notification or late filing," but would maintain that the Council could adopt a policy that denied deferrals to companies that did not file the notice within the required 60 days, and that late filing by some companies may have unfairly extended a company's deferral period.

VEPC outlined a range of positive steps to address this question, which we would support, including adjusting the deferral, if granted, to start on the date that the notification should have been filed under statute, and consulting with the Attorney General's Office on the Council's authority in cases of companies failing to notify VEPC within 60 days of a triggering event as required by statute.

Vermont Department of Taxes

The response from the Department of Taxes focuses on conflicting interpretations of the EATI statute provisions that deal with how the Department reviews tax credit claims in the EATI program.

The Department maintains that the key section, 32 V.S.A. §5930a(1)(1)(B), "clearly provides the Department only two possible courses of action when reviewing a credit:

1. If the Department determines full compliance with all performance expectations, the credits shall be allowed.
2. If the Department is unable to determine full compliance with all performance expectations, the Department shall request the Council to perform a more detailed review.

There is no third option that would allow the Department to disallow credits without requesting a review from VEPC.”

The Department also notes that because 32 V.S.A. §5930a(m)(1)(A) refers back to and relies on the section above, it has correctly followed statutory directives when reviewing tax credit claims.

This Office has expressed the opinion in a past report that the Department of Taxes does have a third option – that of denying a tax credit claim under §5930a(l)(1)(B) when a company fails to meet performance expectations, without sending the matter to VEPC for a more detailed review. Under this view, the Department of Taxes could also, under §5930a(m)(1)(A), recapture and disallow credits when a company failed to meet performance expectations.

Then-Commissioner of Taxes Richard Mallery discussed this issue in his January 31, 2003 response to a previous audit, and concluded that the Department had the authority to deny EATI credits:

It is clear, however, that extended contention with respect to the legal nuances of the manner in which the Tax Department can allow or deny credits is unproductive. 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.

Though EATI awards are terminated as of January 1, 2007, and credit claims from companies with active authorizations will diminish in years to come, there will likely be instances in the future where a company does not meet all performance expectations. We believe the State’s interest would be best served by a definitive opinion on the question of the Department’s ability to directly recapture and disallow credits under §5930a(m)(1)(A) without a review from VEPC.

Therefore, we have revised our recommendation on this issue to include a request to the Attorney General for an opinion on the Department’s authority under §5930a(m)(1)(A).

- - - - -

In accordance with 32 V.S.A. §163, we are also providing copies of this report to the Secretary of Administration, the Commissioner of Finance and Management, and the State Library. In addition, the report will be made available at no charge on the State Auditor's web site, www.state.vt.us/sao.

Any questions or comments about this report can be directed to the State Auditor's Office at 828-2281 or via e-mail at auditor@sao.state.vt.us. George Thabault was the primary auditor of this examination, under the direction and supervision of Timothy Keefe, CPA, Deputy State Auditor.

VERMONT ECONOMIC PROGRESS COUNCIL
ECONOMIC ADVANCEMENT TAX INCENTIVE
PROGRAM
VERMONT EMPLOYMENT GROWTH INCENTIVE
PROGRAM

“BUT FOR” APPLICATION REQUIREMENTS and PROCEDURES

(January 2006)

(NOTE: Procedure adopted by VEPC in January 2006 and implemented informally for remaining EATI applications. Formal incorporation in program documents and procedures not possible by the time program ends. Therefore, some application requirements, such as two signatories, not fulfilled for all applicants in 2006. Application requirements and procedure will be formally incorporated into VEGI program documents, rules and procedures.)

“But For” Application Requirements:

1. Applicant must include the “But For” statement on a form that includes the signed declaration/certification of truth statement currently utilized on the EATI application. Must be signed by two corporate officers, as outlined below.
2. Application and But For statement must be signed by same two corporate officers, as follows:
 - a. If Vermont company, two Vermont officers (ie CEO/CFO)
 - b. If Vermont division, CEO or other top executive of parent company and top Vermont officer.
 - c. If there is an individual majority shareholder, that person may be the sole signatory.
3. “But For” statement must include narrative detail supporting the specific “But For” argument being made by applicant sufficient for the Council to make a “But For” determination. Application must also contain data and/or documentation that supports “But For” statement, as appropriate. For example:
 - If “But For is a “yes” or “no” go decision, who is making that decision and what factors are being considered.
 - If “But For” is based on a locational decision, provide information, including contact information, on other locations and incentives offered.

Appendix I

- If “But For” is about significantly different/less desirable (scope, scale, timing), provide details about how the project would be significantly different and less desirable and include data projections showing the different and less desirable results. This would include “But For” statements that are based on financial need, where the applicant is stating that the project financials would not work without the tax incentives. Information must also address significance of the difference and desirability.
4. After application is submitted and staff reviews “But For” statement, applicant will be sent questions that will help determine the efficacy of the “But For” statement presented by the applicant. Applicant will be required to provide responses to these questions, including any supporting documentation or data, before an application is considered complete. Questionnaire will state that the applicant should be prepared to provide copies of any documents that substantiate their answers. Sample questions include:
- Have you placed ads for the new jobs? Where?
 - Will you need any permits? Have you applied for permits for this project? Have any been approved?
 - Will you purchase, build or lease? Have you negotiated or signed any purchase and sales or lease agreements?
 - Have you made any payments or obligations to architects, engineers, designers for sites in Vermont or elsewhere?
 - Are you negotiating with any economic development officials in (fill in alternate location)? Who are they and what are they offering for incentives?
 - Are any permits in place or applied for in Vermont or in (alternate location)? What type, date?
 - How will the project be financed? Are any elements of the financing plan in place? Equity investors? Bank financing?
 - Will the project receive or has it received any public funds or financing (VEDA, USDA/RD, CDBG)?
 - Is a business plan for this project developed?
5. A checklist of required and optional documents to be provided with the application to substantiate the “But For” will be incorporated into the program documentation:
- a. Required documents from applicant:
 - i. Signed, certified “But For” statement.
 - ii. Information regarding incentives offered by other locales and copies of any specific incentive offers. Include names and contact information for any out-of-state officials contacted.

Appendix I

- iii. Data documenting significantly different/significantly less desirable outcome without incentives or financial need.
- iv. Documents that substantiate “But For” or answers to questions.
- b. Required documents from staff, others:
 - i. Documents supporting accuracy of applicant information, such as:
 - 1. NAICS code verification
 - 2. Average Wage for sector/region (Vt DoL data)
 - 3. Average wage for jobs being created (Vt DoL data)
 - ii. Cost-Benefit analysis
 - iii. RDC, RPC, Municipal letters of support
 - iv. Statement from Tax Department regarding filing status
 - v. Secretary of State listing (from website database)
 - vi. Other documents pertaining to applicant, if they exist (i.e. press releases, media statements, news reports, etc.)
- c. Optional documentation to be provided by applicant. The following should be provided by the applicant, if available. Certain documentation may be required, depending on the nature of the “But For” statement:
 - i. Financial statements
 - ii. Business plan
 - iii. Equity/Financing plan
 - iv. Market information

“But For” Findings of Fact process:

1. ‘But For’ reviewed initially by RDC Director and VEPC Staff.
2. Questions sent by VEPC staff to applicant and response provided by applicant.
3. Application accepted as “complete” only when it meets the mandatory requirements.
4. Staff reviews all documents and verifies information.
5. Staff presents ‘But For’ and supporting documentation/information in a write-up to VEPC Board, supplemented by the information required for Findings of Fact and potential information to use as the basis for reasonable evaluations to support opinions by the Board.
6. Top Vermont executive that signed application and “But For” statement required to attend VEPC Board meeting.
7. During VEPC Board meeting, detailed notes will be kept regarding statements made by applicant relative to “But For” and the questions

Appendix I

- asked by the Board and responses given by applicants, including statements and discussion occurring in executive session.
8. A detailed decision (motion) made by voting Board member and recorded in public minutes.
 9. The public minutes will reflect the motion only, but confidential notes from executive session will be available to those persons authorized by Title 32, Section 5930a (h).
 10. The application file will include a confidential Finding of Fact and Opinion document as outlined below and a copy of the confidential executive session notes.

Definitions for Findings of Fact and Opinion Document:

Preliminary statement

A preliminary statement informs the Board of the basic “But For” information, including the following:

- The nature of the “But For” request:
 - “But For” considered based on location.
 - “But For” considered based on “yes” or “no” go.
 - “But For” considered based on significantly different/less desirable manner.
- That all reasonably available factual documentation to support the “But For” was collected.
- That the applicant’s request for EATI was pre-screened and forwarded with approval by the appropriate Regional Development Corporation, Regional Planning Commission and municipality.
- That a standard set of questions was used as part of the deliberations.

Findings of Fact

Findings of Fact are only those items that consist of written material that is received from a credible source and/or can be validated by a second party finding. The Council will make each fact a separate finding and cite the document supporting each finding. Beyond the documentation required from applicants, all other documentation would be optional. However, statements that are not documented would reduce the ability of the VEPC Board to make a decision based on factual information (Finding of Fact).

Opinions

Opinions are reasonable evaluations made by the VEPC board as they have evaluated the findings of fact presented, as well as subjective opinions derived from responses to questions posed by VEPC members. Ideally the

majority of the listed opinions will be based on a citable finding of fact, and so referenced. For those opinions based on other information, such as those derived by questioning or unsubstantiated written material (example: news article), then the opinion would be annotated that it was formed on non-finding of fact information (question or material).

Decision

The Decision made regarding the award of EATI is based on the finding of facts, and both supported and unsupported opinions arrived at by the VEPC board during the course of deliberations. The Decision must include the vote by the VEPC board for that particular application.

Sample of Finding of Fact and Opinion Report

1. **Preliminary Statement:** On February 3, 2006, the Jim Jones Company filed a complete application for Payroll and Capital Investment EATI credits based on the “But For” of different/less desirable conditions if EATI credits were not awarded. The Springfield Regional Development Corporation reviewed the application and supports the application. All reasonable documentation pertaining to the application were provided by the applicant and VEPC Executive Staff and considered during the application hearing and deliberation process on February 23, 2006. The majority of the questions posed to the applicant during the hearing were those derived by VEPC for such “But For” of “different/less desirable conditions” hearings guideline.
2. **Findings of Fact.** The findings of fact set forth were determined based on the documentation provided.

FF1. The application for EATI was complete and signed by two officers of the company as set forth in the application requirements.

FF2. The ‘But For’ Statement was complete and signed by the same two officers of the company as set forth in the application process.

FF3. The applicant’s EATI form and ‘But For’ form were reviewed by the appropriate RDC and supported by signed letter of support.

FF4. The VEPC Executive Staff provided the cost-benefit analysis, evaluation of EATI guidelines, and recommendation to the VEPC Board for their review.

Appendix I

FF5. The applicant provided their current business plan (2004-2009) dated June 6th, 2004.

FF6. The applicant provided their current independent audit statement of the company finances for 2004.

FF7. The applicant provided a provisional loan document from the M and S Bank to cover the planned Capital Improvement purchases to support production

FF8. The applicant provided a letter from the Department of Education and Training certifying a joint agreement for new workforce training support under the “New Jobs” program.

FF9. The applicant provided a list of Vermont suppliers and vendors required for Guideline 6.

3. **Opinions.** The following opinions, both objective and subjective, were derived by the VEPC members during the hearing and deliberation process on February 23, 2006. Those opinions not followed by a Finding of Fact (FF#) were derived via questioning during the hearing.

O1. That the applicant’s EATI application and ‘But For’ form clearly established conditions for consideration of the application. (FF1 and FF2)

O2. That the RDC has reviewed and supports the EATI application as presented. (FF3)

O3. The Cost-benefit analysis was complete, accurate and logical in regards to the EATI benefits to be derived, and the recommendation provided. (FF4)

O4. The applicant’s business plan developed in the preceding year clearly identified the planned expansion and cited the requirement for favorable conditions that included EATI credits. (FF5)

O5. The applicant’s business is solvent and has assets and market/sales that support logical expansion as proposed. (FF6)

O6. The required financing to support the planned expansion is in place. (FF7)

O7. The applicant demonstrated a commitment to workforce expansion training per interaction with the Department of Education and Training. (FF8)

O8. The applicant provided significant verbal information regarding current market forces and competitive requirements for their business.

O9. The applicant provided comparative market statistics (document) that showed different/less desirable conditions if expansion was undertaken.

Appendix I

O10. The RDC provided significant verbal information regarding workforce availability and local training opportunities to support workforce expansion.

O11. The applicant satisfactorily explained the reasons for the extended Capital Equipment phased purchases.

O12. The applicant clearly defined the advantages that would accrue to its business and Vermont vendors/suppliers to his business if the production line expansion took place.

4. Decision. Based on the Findings of Fact and the Opinions derived from the application hearing and VEPC deliberation process, the VEPC Board, by a vote of 7-0-2 authorizes the Jim Jones Company of Springfield, Vermont the following EATI credits as calculated by the cost-benefit model and recommended by the VEPC Executive Staff:

Payroll Tax Credit:	\$150,000
Capital Investment Tax Credit:	<u>\$450,000</u>
Total	\$600,000

The cost-benefit model predicts the following benefits to the State of Vermont:

Net Revenue Benefit (7 Yrs):	\$150,000
New Full-Time Jobs (7 Yrs.):	25

5. Conditions: The Following conditions must be met to allow the authorized credits: **(List Performance Expectations)**

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council



Vermont Economic Progress Council
National Life Building, 6th Floor
Drawer 20
Montpelier, VT 05620-0501
www.thinkvermont.com/VEPC

[phone] 802-828-5256
[fax] 802-828-3258

Fred Kenney, Executive Director

December 27, 2006

The Honorable Randolph Brock
Auditor of Accounts
State of Vermont
132 State Street
Montpelier, Vermont 05633-5101

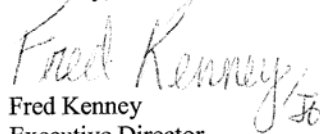
Dear Randy,

Enclosed are the Vermont Economic Progress Council responses to the draft audit of the Economic Advancement Tax Incentive program.

I want to thank you and your staff for the manner in which this audit was undertaken. Staff was professional, responsive, and committed to understanding a very complicated program.

Thank you for your consideration.

Sincerely,


Fred Kenney
Executive Director

Enclosures

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council

RESPONSE TO THE 2006 STATE AUDITOR'S REVIEW OF THE ECONOMIC ADVANCEMENT TAX INCENTIVE PROGRAM

by

THE VERMONT ECONOMIC PROGRESS COUNCIL

SUMMARY

The Vermont Economic Progress Council ("the Council") hereby submits its response to the 2006 Draft Compliance Audit ("the audit") of the State Auditor concerning the internal control and compliance review of the Economic Advancement Tax Incentive (EATI) program.

The Council appreciates the thorough nature of the review, particularly the professional audit standards and methods upheld and employed during this audit. In summary, the Council identified one specific finding to which a remedy is required. The Council's responses to the specific audit findings that pertain to the Council's administration of the EATI program are below. The Council will endeavor to make corrections in policy and procedures as required to conform to the audit findings and will seek legislative remedies where required.

DETAILED RESPONSE TO FINDINGS/RECOMMENDATIONS

"But For" Procedures (Page 10 – 12):

The Council takes the responsibility of the "But For" (32 VSA §5930a(c)) decision very seriously and values the critical role this evaluation played in the fiscal integrity of the EATI program. This aspect of the program is especially important in that it continues as the main "gateway" approval criteria for the new VEGI program.

Members believe that generally, applicants to the business incentive programs - most of whom are Vermont small business owners - are honest and trustworthy people. They also believe that applicants would not sign their application and 'But For' statement unless it were true. However, VEPC members also believe in "trust, but verify" and realize that by hearing these business people make their case in executive session (as required by law), the reasoned deliberation that leads the Council to their 'But For' decisions is not visible to those who are charged to ensure that the process meets statutory requirements. That is why the Council implemented a new "But For" Finding of Fact and Opinion process early in 2006.

The Council must balance their responsibility to the fiscal integrity of the state and the requirements of statute with making a subjective judgment and avoiding a process so onerous as to discourage applicants based solely on administrative difficulty. The Council is committed to implementing a process that finds this balance.

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council

The “But For” process initiated by the Council (See Page 25 of Audit) was based on input from the Auditor and others. It is meant to provide a consistent ‘But For’ process that maintains the balance mentioned above, while providing the Auditor and others with statutory access to incentive applications documentation of the decision process.

The Council is appreciative of the input received from the Auditor on this issue while the process was being developed. Most of the elements of this procedure and some of the requirements for the applicants that are contained in the procedure are not new. Instead, this is a formalization of practice and documentation by the Council of that practice so that there is a written record of the decision-making process.

The Council pointed out to the audit staff and the document (See Page 25) clearly states that not all aspects of the procedure could be implemented immediately. The elements of the procedure that the Council can implement on its own have been implemented as noted by the audit. The Council is:

- Asking for more information and more detailed information in support of the “But For” statement;
- Asking that specific questions be addressed in writing;
- Keeping confidential meeting notes from executive session.
- Producing a “Finding of Fact and Opinion” document for each decision.
- Requiring the attendance of top company officials at meetings.

However, application documents, forms, literature, and website information on the EATI program were already in the public domain. Those documents already contain the application requirements and forms that were in place before the Council implemented these changes. Revising and reissuing these documents when all new documentation will be required a few months later for the new VEGI program would represent a waste of the Council’s very limited resources.

The Council has fully implemented the steps it can take on its own. With the publication of the new VEGI materials, the process will include the additional steps by applicants and information that must be submitted by the applicants. For example, contact information for out-of- state economic development officials and two signatures from the applicant company. A look at the program literature, guidebook, and application forms developed for the VEGI program (See www.thinkvermont.com/vepc) show what will be required of applicants. Those requirements, combined with the steps already taken by the Council demonstrate full implementation of the process outlined in the Council’s January 2006 “But For” process document.

The Council’s “But For” process instructions are not contradictory. The documents listed as “optional” are not required to be filed with the application, unless they are directly relevant to the “But For” claim being made by the applicant (i.e. a financial plan if the But For is about the project not being financially viable without the incentive). However, the Council may require that one or some of these documents be submitted if the Council needs that level of information to substantiate the But For claim.

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council

The statute does not require the submission of business plans or detailed financial statements from applicants for a good reason. Such documents may not be relevant and may not be already prepared. For a small/medium-sized business, producing a business plan if one is not required for the decision at hand is an unreasonable burden to be placed on an applicant.

The Council cautions against expectations that because contact information on out-of-state economic development officials is required (if relevant) and provided, that those people will actually be contacted by the Council. The statute does not provide the Council the authority to conduct investigations, nor is the Council provided sufficient resources to conduct investigations or verification of every fact presented in an application.

The Council reiterates that the “But For” clause requires an affirmative decision to the best of the Council’s judgment. This requires an examination of the evidence to the extent that a reasonable person can make a decision with the material presented by an applicant.

Application Amendment Procedure (Pages 12-13)

The Council did not improperly amend an application. The audit included only a partial statement of the procedures in place for situations similar to this. The full procedure states:

“Section 7. Reapplication

- a. The Council will accept and review applications from applicants who are currently authorized for incentives or who have previously been authorized for incentives and completed their authorization period, under the following procedures:
 1. **APPROVED APPLICANT, DIFFERENT PROJECT:** An entity that has previously been approved for tax credits may, at any time, submit an application regarding a new economic activity. The Council will compare the new application to the previously approved application to determine whether the new economic activity is clearly a new project, completely separate from or in addition to activity represented in a previously approved application. If so, the application is considered new and will be subject to the normal review process. If the subsequent application is filed within seven years of the previous application, for cost-benefit modeling purposes, only jobs and payroll that is above and beyond that included in the first application will be counted.
 2. **APPROVED APPLICANT, SAME PROJECT:** Increased investments in an approved project will not automatically lead to the authorization of additional tax incentives. If circumstances

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council

concerning an approved project change, the applicant may re-apply. Any revised applications will be subject to the normal review process, *including meeting the “but for,”* undergoing a cost/benefit analysis and addressing the guidelines. In determining whether a new application for a previously approved activity should be reviewed, the Council will consider the amount of time elapsed since approval and the degree of change in the application. If the subsequent application is approved and none of the investments represented in the original approved application have occurred and, therefore, no credits have been earned or claimed, the previously approved application will be null and void. If the circumstances regarding an approved project have changed but some of the investments have been made and, therefore, some of the credits have been earned or claimed, an approved applicant may submit a new application. However, the Council will consider the degree to which the change was a result of unforeseen circumstances and beyond the control of the applicant. If the subsequent application is approved, the previously approved application will be null and void, except that any credits claimed and approved by the tax department will be deducted from those awarded by the new application.

3. **APPLICATION AMENDMENTS:** An approved applicant may request an amendment to an approved application for issues that do not substantially change the application. Any amendment must be consistent with the original “but for”, guidelines, and cost-benefit model. The amendment must be requested and justified in writing and be requested within the five-year period that commenced with the approval of the original application.”

The application in question fell into category 2 and the circumstance that changed was the location, within Vermont, of the project. New jobs and payroll would be created, but in a different location within Vermont. The incentives approved were based on those jobs and a certain level of capital investment in plant fit-up. As with any activity in any application, the Council is considering whether the project will occur at all, in Vermont, or in a significantly different and less desirable manner. The “But For” in this case was about whether those jobs and that level of capital investment would occur **in Vermont**. When notified of the changed circumstances, the question before the Council was whether further incentives could be approved because more capital investment would occur in the new location because the company would build a new building and invest in fit up instead of leasing a facility and paying for fit-up. The Council denied any increase because increased incentives would not be a factor in the decision to locate the project in the new location within Vermont even though the applicant would invest millions more at the new location.

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council

The original “But For” still applied to the jobs and payroll to be created and the capital investment for which an incentive was offered. All Guidelines were reexamined for the new location and found to be met. The cost-benefit model was rerun and the Council found that the business would be eligible for a substantial increase in incentives because of the increase in capital investment at the new location and the increased multiplier effects of creating jobs in the new location. However, as discussed, the Council decided to maintain the original amount of incentives approved, **in accordance with the procedure**. It should be noted that the net revenue benefit to the state tripled because of this course of action. Also, the current jobs and operations of the applicant are not impacted.

Procedures cannot conceive of every situation that might occur. In this case, the procedures worked as expected. But if a situation arises that is not covered by a procedure, the Council will proceed in accordance with statute and using common sense. If the procedures did not apply with this application, the “But For” as presented for the authorized amount of incentive for the level of economic activity still applied, the Guidelines were met and the cost-benefit model indicated a substantial positive return for the state.

Further, the Council provides the following comments:

- A letter from the applicant regarding the change in location for the project is contained in the applicant file.
- The applicant did not request an amendment. The applicant informed the Council of the change in location – within Vermont - of the project.
- The Council did not amend the approval as to do so could require a change in the amount of incentives.
- The notice to the applicant did not state that the Council amended its approval. It stated that the decision was to maintain the original authorized amount. The notice indicated that the authorization documentation was changed to reflect the new location. The applicant is expected to reach the same performance expectations to earn the incentives authorized, but at a different location within Vermont.
- VEPC staff stated that the change in location could not meet the “But For” in the manner that would be required to increase the amount of incentives to reflect the substantial increase in investment that will occur at the new location. However, the “But For” remained met for the creation of the new jobs and the level of investment originally projected.

Cost-Benefit Model Procedures (Page 13)

The Council appreciates the thorough review of the cost-benefit modeling procedures and process. The cost-benefit model is integral to the incentive program and works in conjunction with, and helps validate, the “But For” findings to ensure that only incremental activity is authorized for incentives.

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council

As required by statute, the Joint Fiscal Committee has been notified of all updates to the model and approval has been sought and given for all model modifications, including the major modifications required to implement the VEGI program. Annual model update notifications will be provided to JFC under the VEGI program and requests for approval any required model modifications will be sought.

Past model versions are required to accurately model economic activity during post-approval processes including performance expectation reviews and disallowance- recapture reviews due to a curtailment in employment. These reviews will continue over the coming years until all the EATI authorizations expire.

Performance Expectation Review Procedures (Page 14 – 15):

The finding in this section applies to the Department of Taxes. However, the Council participates in this review process and points out that in regards to 32 VSA §5930a(m)(1)(A), the provision refers back to 5930a(l) which states that VEPC is to recommend that a credit be approved, “*in full or in part*, or disallowed,” which is the recommendation Tax upheld in this case (emphasis added). Part of what was already earned through appropriate economic activity was allowed. Further, Section 5930a(m)(1)(A) refers to “*all* performance expectations upon which the award was conditioned.” Awards are conditioned and calculated based on the activity and the expectations for the entire life of the activity approved, not just one year’s activity and expectations. Each year’s performance is evaluated in relation to that year’s activity and expectations. The question addressed by 5930a(m) is whether incentives already “taken” (earned and applied) should be recaptured and/or incentives “remaining to be exercised” (unearned and earned , but not applied) should be disallowed.

Disallowance/Recapture - Deferral and Mitigation Procedures (Page 15 – 20)

With this finding, the audit has astutely identified a weakness in the statutory provisions controlling the disallowance and/or recapture of incentives due to a substantial reduction in employment by an authorized business (VSA 32 §5930h(c-f)). The provisions require an authorized business to file a notification with VEPC within 60 days of falling below a certain level of full-time employment. The issue also involves the annual reporting requirement by authorized businesses (VSA 32 §5930a(l)(1)(A), which requires authorized businesses to file an Annual Activity Report with the Tax Department and VEPC on or before the date their Vermont tax return is due, including any filing extensions.

The underlying issue is the reliance on self-reporting by businesses. Since the beginning of the program, companies in the program have been required to self-calculate any recapture amount and report it on their tax return for the year they triggered this recapture (VSA 32 §5930h(c)(2)). Since July 1, 2003, companies have been required to file a

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council

notification with VEPC within 60 days of falling below 75% of their highest level of employment for 120 consecutive days during the authorization period (32 VSA §5930h(e)).

This reporting and notification system is flawed for several reasons:

- It relies on self-reporting by the businesses.
- It is extremely difficult for a business to know how to calculate a recapture amount to report.
- It is difficult for a business to know what level of employment triggers the recapture and requires a notification.
- If a business does not report or provide notification, the Tax Department and VEPC will not learn of the severe reduction in employment until a business files their tax return and Annual Activity Report. With extensions, this filing can occur months after the fact.

This finding properly illuminates a question caused by the factors enumerated above: If a company does not file the notification with VEPC that they have fallen below the disallowance/recapture trigger level, should that company be allowed to petition for a deferral or mitigation of disallowance/recapture?

There is no statutory authority for the Council to bar a petition for deferral or mitigation based on a failure to file this notification. No provision addresses or even contemplates a potential Council response to a failure to file the required notification on time. While the statute does articulate specific conditions under which deferral can be granted and mitigation allowed and calculated, there is no mention of the Council having authority to outright deny a petition.

Generally, authority to take punitive action that would adversely affect a person's property interest is spelled out in detail in the law, especially if filing a notice as little as one day late would trigger as severe a response as an automatic forfeit of any opportunity to seek deferral or mitigation. Specific statutory language not only provides clear authority to a state agency, but also provides fair notice to the persons potentially affected. Here, the statute is silent on the potential consequences of a business not filing the notification or filing late.

Because it is possible that the required notification may not be filed on time, causing VEPC and the Tax Department not to learn of the employment reduction for several months after the fact, the following may be an appropriate scenario allowed by current statute in these cases:

- Notification is not filed or is not timely.
- The Council or Tax department identifies the business as triggering this recapture provision and notifies the business.
- The business petitions for deferral.
- The Council determines that the statutory requirement to grant a deferral is met.

Appendix II

Comments From the Executive Director, Vermont Economic Progress Council

- However, because notification was not filed by the company or was not timely, the deferral, if granted, must start on the date that the notification should have been filed (60 days following the 120th day business is below the recapture level of employment), rather than the date the deferral is approved.

A minor issue identified by the audit is the level at which the recapture level is set by VEPC in the notification to the company. In one case, the audit found that the level was set *at* the minimum recapture level instead of *above* the minimum recapture level. The Council agrees that the statute requires that the employment level in the notification which must be reached be above the minimum recapture level.

The Council will take the following steps to remedy these findings:

- 1) Consult with ACCD Counsel, the Attorney General's office, and the Tax Department counsel, as appropriate, to determine:
 - a. The Council's authority to deny deferral in these matters or to adjust the deferral start date.
 - b. If the Council and/or the Tax Department, by policy and procedure, can require employment level reporting by company's in the program on a more frequent basis, such as semi-annually.
 - c. Whether the issue can be resolved through the establishment of a procedure or if a statutory change is required, or both.
- 2) Seek a statutory change, if required.
- 3) Establish any policies and procedures, as required.
- 4) Notify all program participants of any statutory or procedural changes.
- 5) Review, in consultation with the Tax Department, all cases that have been considered under VSA 32 §5930h and take appropriate remedial action, if appropriate and required.
- 6) Review all deferrals granted to check the minimum employment level stated to ensure the level is set above the minimum recapture level (i.e. the minimum recapture level, plus one) and notify any program participants of any changes resulting from this review.

Appendix III

Comments From the Commissioner of Taxes



State of Vermont
Department of Taxes
133 State Street
Montpelier, VT 05633-1401

Agency of Administration

December 27, 2006

Mr. Randolph D. Brock
Vermont State Auditor
132 State Street
Montpelier, VT 05633-5101

Re: Tax Department Response to EATI Compliance Audit

Dear Mr. Brock:

Enclosed in the body of this letter is the Tax Department response to the draft of the compliance audit of the Economic Advancement Tax Incentive program performed by the State Auditor's Office, and forwarded to the Department on December 15, 2006. Please contact our office if the format of the report will change, in order that we may make the necessary adjustments to references, page numbers, and sections.

Introduction:

The Auditor reports one specific criticism of Tax Department administration of the EATI program in the "Highlights", "Audit Results", and "Conclusions" sections of the report.

Pages 3, 14, 15, and 23 of the Auditor's report state that the Department of Taxes has failed to follow statute requiring recapture and disallowance of credits in the event that a company fails to comply with all its performance expectations.

The Department will provide a single response to the Auditor's first recommendation ("Recommendations" p. 23), which encompasses the criticism that appears earlier in the report.

Looking Forward:

It is important to note that the issue of recapture and disallowance based on performance expectations has been addressed upon the recommendation of the Administration by the Legislature. The Vermont Employment Growth Initiative (VEGI) was enacted in 2006 and becomes effective January 1, 2007. VEGI, which replaces the EATI program, is structured such that companies *must* meet or exceed targets in order to earn an incentive. There is no provision for review or discussion if a company fails to meet its targets. Incentives will be earned based on the creation of new jobs and payroll, and paid out over a period of five to nine years as jobs are retained.

This design eliminates the significant administrative burden of "Performance Expectation Reviews," which are required as a part of the EATI program and are subject to criticism by the Auditor's Office



Appendix III

Comments From the Commissioner of Taxes

as well as participating companies. Further, the five-to-nine year payout model reduces the need for credit recapture. This system ensures that incentives are paid only after the new jobs have been retained long enough to generate a net fiscal benefit to the state.

VEGI's streamlined claiming process is one of several substantial improvements based directly on experience with the EATI program.

Audit Recommendation:

First recommendation, p. 23:

“The Department of Taxes should follow statutory requirements to recapture utilized credits and disallow unearned credits when the taxpayer fails to comply with all performance recommendations.”

Tax Department Response:

The Department of Taxes maintains that it has followed the plain language of relevant statutes in cases of failed performance expectations, and specifically in the case cited in the Auditor's report.

The legislature chose a procedure where the review is performed by the Council. This allows the Council to make a recommendation based on the same considerations made at the time of the original award.

The audit finding did not cite the relevant state statutes together and in full. As support to the Department's position, the two sections are cited below:

1.) 32 V.S.A. §5930a(l)(1)(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 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 performance expectations, the department shall request that the council conduct a more detailed review.**”* (Emphasis added)
(The statute goes on to describe the review process, require that a report be provided to the Tax Department, and provide the Tax Department discretion to accept or reject the recommendation.)

§5930a(l)(1)(B), above, clearly provides the Department only two possible courses of action when reviewing a credit.

1. If the Department determines full compliance with all performance expectations, the credits shall be allowed.
2. If the Department is unable to determine full compliance with all performance expectations, the Department shall request the Council to perform a more detailed review.

There is no third option that would allow the Department to disallow credits without requesting a review from VEPC.

2.) 32 V.S.A. §5930a(m)(1)(A)

The second relevant sub-section of statute states that credits shall be recaptured (paraphrase) in the event that...

Appendix III

Comments From the Commissioner of Taxes

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

The closing language of §5930a(m)(1)(A), “...and determined by the department of taxes under subsection (l) of this section,” refers to the review process that the Tax Department and VEPC must undertake if the Department can not determine full compliance with performance expectations. VEPC conducts a review of the actual activity of the company, which may include re-running the cost-benefit model, and provides a recommendation to the Tax Department. The Department can choose to accept or reject the recommendation.

Summary of Statutes

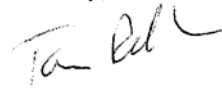
Taken together, these sections [§5930a(m)(1)(a) and §5930a(l)(1)(B)] instruct that the Tax Department shall disallow/recapture credits for failure to meet performance expectations *unless a VEPC recommendation to allow credits has been accepted by the Tax Department.*

In the case cited in the Auditor’s report (“Audit Results”, pp14-15), this statutory review process was followed exactly. The company claimed a fraction of its authorized credits, and based its claim on actual activity. However, the company fell short of performance expectations, so the Department requested and received a detailed review from VEPC. The cost-benefit model demonstrated that the 20+ jobs created and the \$1 M additional payroll resulted in a net fiscal benefit to the state, even after allowance of the credits was considered. The Department accepted the recommendation to allow credits.

The Department of Taxes maintains that statutory directive was followed, and the decisions that resulted were responsible to the state treasury.

The above statement closes the Tax Department’s response. Please contact Dale Macomber, Internal Audit Section Chief, at 828-2556 if you have any questions regarding the information above.

Sincerely,



Tom Pelham
Commissioner of Taxes