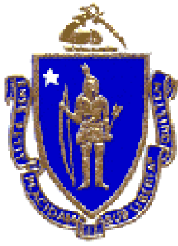

The Commonwealth of Massachusetts

Office of the Inspector General

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January 23, 2004

Alan LeBovidge
Commissioner
Massachusetts Department of Revenue
100 Cambridge Street
Boston, MA 02114

Dear Commissioner LeBovidge:

The Office of the Inspector General (OIG) believes that the abuse of economic development tax credits is costing the taxpayers millions of dollars. This letter contains several specific examples of this abuse totaling more than $10.5 million. The OIG is notifying the Department of Revenue (DOR) of this so it can take immediate action to prevent this abuse. DOR must act to safeguard approximately $100 million per year in economic development tax credits[1] granted by the Commonwealth from vulnerability to fraud, waste, and abuse. Businesses use these tax credits to reduce their Massachusetts tax liabilities. The continued vulnerability of these tax credits may undermine their long-standing purpose of economic growth and job creation by misdirecting tax dollars from true economic development.

In a statement issued in December 2002, the OIG called for the immediate implementation of a system to verify that these tax credits have been used appropriately, that credits were granted only to *bona-fide* projects, and that taxpayers have received their money's worth from these credits. The Department of Business and Technology's (DBT) pending changes to the regulations that govern the Economic Development Incentive Program (EDIP) tax credit largely ignore the OIG's call for immediate reform.

The EDIP, managed by DBT, is an example of a tax credit program in need of reform. According to DBT, the EDIP is intended "to foster business growth and foster job creation" and "to attract and retain businesses in specific economic target areas" within Massachusetts by providing “a mechanism by which municipalities can stimulate economic development in economically-

[1] These credits include, but are not limited to, the Incentive Tax Credit, the Economic Opportunity Area Credit, the Economic Development Incentive Program Credit, the Full Employment Credit, and the Research Credit.

distressed areas."[2] An essential component of the EDIP is the five-percent state tax credit.

The OIG's review of the EDIP identified the apparent misuse of EDIP tax credits. Businesses usually become eligible for tax credits through an action taken by a state agency. In the case of the five-percent EDIP tax credit,[3] the Economic Assistance Coordinating Council (EACC), chaired by the Director of DBT,[4] approves the creation of an economic opportunity area (EOA). A business located within an EOA is eligible to claim the EDIP tax credit. Between the creation of the EDIP tax credit in 1993 and tax year 2002, businesses have used more than $110 million in EDIP tax credits to offset Massachusetts' taxes. The total of all economic development credits used by businesses during this same period exceeds $500 million.

The OIG review of the EDIP identified that although EOA approvals that trigger millions of dollars in tax credits must be based on statutorily created criteria, the EACC has granted approval in numerous cases where the criteria had not been met. Also, the OIG review found that there is virtually no review and verification of the information businesses submit to the EDIP as the basis for a tax credit request. In fact, the OIG could not identify one case of the EACC turning down a business for a tax credit in the program's history. A December 2002 report by the Senate Post Audit and Oversight Committee revealed that the EDIP has been reluctant to revoke approval for tax credits even when cause exists.[5] The OIG review has found that even though the EACC has the statutory obligation to continually evaluate and investigate these agreements and the authority to revoke the designation that allows the tax credit, the EACC has rarely exercised its authority.

Little oversight exists for the EDIP and for other tax credit programs at state agencies, including DOR. This lack of oversight is due in part to staffing. Since 1999, the DBT staff has fallen from 38 employees to 18 employees. In a January 2003 letter to the Governor, the Senate President, and the Speaker of

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[2] DBT web-site.

[3] According to M.G.L. c.63, §38N, "A corporation . . may take a [EDIP] credit against the excise imposed by this chapter [c.63] in an amount equal to five percent of the cost of the property that qualifies for the credit . . . ."

[4] By statute, an Economic Assistance Coordinating Council (EACC) composed of 14 members, including: the Director of Business and Technology as co-chairperson; the Director of Housing and Community Development as co-chairperson; the Director of Labor; the Director of Workforce Development; a staff representative designated by the Director of Business and Technology; the Deputy Director of Business and Technology; the President of the Corporation for Business, Work and Learning; and seven other members appointed by the governor, administers the EDIC program with the assistance of staff from the Department of Business and Technology.

[5] Senate Post Audit & Oversight Bureau, Policy Brief, *Return on Investment?*, December 2002

the House, the OIG stated that severe staff reductions at DOR had "led to the virtual discontinuance of field audits." The OIG believes that staff reduction and a lack of strong program controls and guidelines have set these programs up for failure, and made them vulnerable to fraud, waste, and abuse.

Last spring, the OIG requested and received from DOR aggregate statistical information for various economic development tax credits used by businesses to offset their Massachusetts taxes. According to DOR, between tax years 1994 and 2000, businesses claimed EDIP credits nearly 3,000 times for a total of $45 million. However, within the same time period DOR only disallowed the credit eight times for a total of $145,000. DOR also informed the OIG that tracking of and accounting for tax credits is haphazard and incomplete. DOR does not have information relating to EDIP credit disallowances for fiscal years prior to 2000 and DOR cannot track more than four credits. For example, if a business claimed four credits of any type with a higher value than the EDIP credit, DOR's Audit Division could not track the EDIP credit. To the knowledge of the OIG, no accurate statistical information is kept by any agency regarding the value of local property tax credits that have been granted to businesses under these incentive programs. The nature of program oversight by DOR and DBT indicates that there is no accounting of the cumulative value of tax credits granted by the state and municipalities.

The OIG intended to pursue a tax credit review in greater detail, but DOR has informed this Office that because of the confidentiality of tax information, DOR cannot provide the OIG with any specific business taxpayer information. For example, DOR could not provide the OIG even with the names of the businesses who have used tax credits. The OIG desires to continue its investigation and receive the full cooperation of DOR. In the interim, the OIG, in an effort to keep DOR aware of the misuse of tax credits, is providing DOR with the following examples.

The Definition of an Economic Opportunity Area has been Abused.

Massachusetts' statute (M.G.L. c.121A, §1) clearly defines what blighted, decadent, and economically distressed areas are. An economic opportunity area (EOA) refers to economically distressed, high unemployment areas without prospects for growth and development. The Legislature specified that only 20 economic target areas would be created in Massachusetts. Through legislation, the Commonwealth opted to provide incentives in the form of tax credits for businesses to relocate to EOAs because it was thought that without the incentives businesses would not move to an EOA. However, the agencies responsible for granting tax credits either ignore these legal definitions or stretch these definitions to the point where they are rendered virtually meaningless. This

approach only weakens the incentive program and makes it less likely that scarce tax dollars will be used to impact areas afflicted by poverty, unemployment, and blight.

Misuse of tax credits exists across the nation. Recently, a California Appellate Court struck down a tax incentive agreement in an affluent suburb in Los Angeles County that was 98 percent residential.[6] The California Appellate Court found insufficient physical and economic evidence to establish that "blight" existed in the suburb with the tax incentive agreement.[7] In Massachusetts, the EACC has designated certain EOAs as blighted or decadent because they appear unlikely to be developed by the operation of private enterprise. The economic evidence contradicts the EACC's conclusions. The following examples illustrate this point.

***Example One*: Manulife Financial received tax credits to construct a new office building in an area already considered highly developable.**

Manulife Financial Corporation[8] is consolidating its Boston operations in a newly constructed $140 million office building on the South Boston waterfront. The building is near the site of the new Boston Convention Center, the World Trade Center, and a number of new or planned commercial and residential developments. This area has been referred to in the press as the new "seaport," the "new jewel of the City," and the "envy of the nation" where land has been selling for millions of dollars per acre. Also it has been described by one development firm as "prime, downtown, waterfront real estate" that has "touched off a scramble" by businesses to leave their downtown addresses in exchange for a waterfront address.

Manulife is planning to relocate approximately 700 employees from space it currently leases in downtown Boston to the new "seaport." This move will add approximately 150,000 square feet to the amount of vacant office space in downtown Boston. According to real estate industry sources, office vacancy rates in Boston are predicted to reach 17 percent this year. Manulife intended originally to use only a portion of the new building for itself while leasing out the remainder. Between planning for this new building and securing state and local tax credits, Manulife made an acquisition that changed its plans.

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[6] Beach-Courchesne v. Diamond Bar, 95 Cal. App. 2nd, 265 (2000)
[7] Beach-Courchesne, 265 Call. App. 2nd at 268.
[8] Manulife describes itself as "a leading Canadian-based financial services company, operating worldwide, offering a diverse range of financial protection products and wealth management services."

Recently, Manulife purchased John Hancock Financial Services, a Boston institution, for $11 billion making Manulife the second largest life insurer in North America with real estate assets, not including Hancock's, of nearly $3 billion. Before Hancock's acquisition, some of Manulife's shareholders criticized the company for not using its significant accumulated capital for expansion.

Although work on the new Manulife building began in 2001, the Boston Redevelopment Authority (BRA) and Manulife did not apply for the state-approved tax credits until May 2003. The official celebration of the new building occurred on March 20, 2003, two months before the approval of the tax credit. Although the local property tax break offered to Manulife is small in comparison to other projects (probably less than $100,000 but this is dependent upon the future assessed value of the property), the approval of this local tax break triggered a much more lucrative state tax break for Manulife -- the five-percent EDIP credit. Based on BRA calculations, this tax break will be worth $7 million to Manulife over the next ten years.

Manulife acquired the rights to develop this property in 2000 from Massport after a “robust competition” that involved six other businesses. Press reports at that time referred to this competition as "controversial" process for a “coveted” parcel of land that involved a former Massport official representing Manulife. Six well-financed businesses indicated a readiness and willingness to develop this property through the ordinary operations of private enterprise. Nonetheless, two and a half years after this robust competition, the EACC approved the parcel as an EOA, reasoning that as "blighted" area, it could not be developed through the ordinary operations of private enterprise. The OIG takes issue with the EACC’s determination that the tax credit is needed because the property could not be developed otherwise.

Manulife's application to the state requested that the 1.5 acre site of its new building located at the South Boston Waterfront, designated as an EOA, also be approved for the tax credits. Furthermore, Manulife's application stated:

- "It is necessary that Manulife USA reduce its overall project costs for this expansion in order to maintain its position in a difficult economy and make possible future employment in Boston, Massachusetts."

  Manulife made this statement at the same time it negotiated for the $11 billion purchase of Hancock and its own shareholders were criticizing the retention of too much capital.

- "The area proposed for designation as an EOA is a blighted open area."

> M.G.L. c.121A, §1 defines a blighted open area as "a predominantly open area which is detrimental to the safety, health, morals, welfare or sound growth of a community and which is predominantly open because it is unduly costly to develop it soundly through the ordinary operations of private enterprise . . . ."

Considering the fact that six financially strong bidders were ready, willing, and able to develop the property as evidenced by the bid competition, Manulife's assertion that the property could not be developed by the ordinary operations of private enterprise is self-evidently false.

The Commonwealth granted Manulife, a financially strong business, a tax credit for vacating leased office space when there existed a glut in the office space market and for building a new office building in an area that did not fit the definition of "blighted."

The OIG recommends that DOR review and, if warranted, disallow all future EDIP tax credits taken by Manulife. DOR's Schedule EOA instructions describes an EOA as: "an area designated by the Economic Assistance Coordinating Council (EACC) to be a 'decadent area' or a 'blighted open area' which is detrimental to the sound growth of a community and unlikely to be developed by the ordinary operation of private enterprise." Clearly, any credit claimed by Manulife would not fit this DOR description.

***Example Two*: Affiliated Manager's Group receives a tax break for moving to one of the wealthiest areas in Massachusetts.**

On March 29, 2001, the EACC approved the creation of the North Beverly EOA as a "decadent area." This EOA encompasses a single 88-acre site in the Pride's Crossing section of Beverly including the historic Loeb[9] estate. The EACC declared this site a "decadent" area that could not be developed through the ordinary operations of private enterprise. At the same time, the EACC also approved a 15-year tax credit agreement between the City of Beverly and the site's owner, Affiliated Managers Group Incorporated (AMG).[10]

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[9] The former home of William Loeb, the publisher of New Hampshire's the *Manchester Union Leader* newspaper.

[10] AMG describes itself as "an asset management company with equity investments in a diverse group of growing, mid-sized investment management firms . . . As of September 30, 2003, the Company's affiliated investment management firms collectively managed over $81.9 billion in assets in approximately 150 investment products. . . ."

In the City's application for the creation of a North Beverly EOA, it contended that: “it is unlikely the area will be redeveloped by the ordinary operations of private enterprise” and that the property is in effect “not developable.” According to the EACC's March 29, 2001 meeting minutes, it did not discuss or dispute this contention.

This EOA encompassed only a single, large estate in the affluent “gold coast” community of Pride’s Crossing. The tax credits would, in effect, subsidize the renovation of the Loeb mansion. The City's assertion that the area remained undevelopable is false. In 1998, Toll Brothers Incorporated, "the nation's leading builder of luxury homes," purchased an option to build a 58-lot subdivision of *luxury* homes on the site. The area is zoned for one-family residential housing and “enjoys commercial grandfather status.” After having approved a preliminary proposal the year before, in January 1999, the Beverly Planning Board rejected the Toll Brothers proposal. The Toll Brothers appealed and in early 2000, during the appeal process, the site's owner sold the property to AMG.

According to AMG documents filed with the SEC in December 1999, AMG stated that it had purchased property in Pride’s Crossing for the construction of a new corporate headquarters. Also, AMG stated in its 2000 annual report that it would build a new headquarters at the Pride's Crossing location. From information reviewed by the OIG, similar to the Manulife example cited above, it appears that AMG planned to move to Pride's Crossing with or without a tax break. In December 2000, AMG filed its tax break application with the City approximately eight months after it had purchased the Loeb property and more than one year after it signed a purchase and sale agreement. AMG reported in its application that: "the construction of the proposed facility is scheduled to begin in June of 2000, with a projected completion date in June of 2001.” Since AMG already planned and promised the facility to its shareholders, the statement in the EOA application that: “it is unlikely the area will be redeveloped by the ordinary operations of private enterprise” without the tax credit is clearly false.

The AMG application also stated that: “AMG is seeking project certification because the incentives offered under this program will allow AMG to remain competitive and expand its operations by reducing some of the company’s associated business costs. The reduction in overhead will provide AMG with the financial resources necessary to target additional mid-sized investment firms, expand its operations, add additional employment and boost the local economy in Beverly.” Notwithstanding whether or not AMG would gain a competitive advantage over other investment companies through a large tax break, the statutory requirement for the awarding of a state tax credit requires that the applicant demonstrate that the site cannot be developed through the ordinary operation of private enterprise.

Based on the facts stated above, this location falls under neither the spirit nor letter of the statutory definition of a "decadent" area. Pride's Crossing is one of the wealthiest areas in the Commonwealth, and it was *not* improbable that the site would be "redeveloped by the ordinary operations of private enterprise." The EACC stretched the definition of "decadent" area to accommodate AMG. Toll Brothers had a development proposal on the table. The agreement between AMG and the City, signed by AMG's Chief Financial Officer, attested falsely that AMG met the criteria for EOA designation.

Of great concern to the OIG is the fact that the EACC took no action concerning serious questions raised by the press in 2002 concerning the validity of AMG's tax break. According to EACC meeting minutes, neither the EACC nor DBT took action to investigate the allegations. The serious issues raised would have refuted the contention that the area was undevelopable by the ordinary operations of private enterprise and would have provided grounds for the EACC to revoke the EOA designation.

As a result, the use of the tax credit for AMG was unjustified. The OIG believes that DOR should disallow all future EDIP tax credits for AMG and take appropriate actions to recoup the more than $1 million in tax credits given AMG to date.

Incentive Program Oversight is Ineffective.

***Example Three*: A lack of rigorous oversight allows businesses to benefit from tax credits to which they may not be entitled.**

The EDIP program has benefited a number of businesses where the return on the taxpayer's investment has been questionable at best. For example:

- Last year an attorney hired an administrative staff person for $13 per hour and received local property tax credits of more than $2,000. A realty office did the same and has received tax credits as well.
- One local supermarket chain received sizeable tax credits for building a new store less than half a mile from its former store. Most of its "new hires" would be part-time employees that do not satisfy the tax credit requirements.
- A local bank has received more than $2 million to date for moving its headquarters from one economic target area to another. The state is subsidizing a move from one economically distressed area to another. In this

case, the economic loss to the one community would nullify the gain to the other community.

- One business that has received more than $500,000 in tax credits since 1997 actually had 41 fewer employees in 2003 than they did in 1997. The business promised to create 150 new jobs. The OIG is aware of no action taken to question this business concerning their promised job creation. This business has also received $4 million in tax-exempt bond financing from the local redevelopment corporation and nearly $200,000 in job-training grants from the Commonwealth.

- Massachusetts Electric, a public utility, received both state and local tax credits for moving a district office from one economic target area to another. This appears to be a state sponsored zero-sum economic development exercise. The utility promised to create three new jobs over a ten-year period in return for this tax break. The location that the utility moved to already housed a facility owned by the utility.

- Businesses use their state tax credits before they have completed construction or renovation of their facilities or before they have hired one new employee. Some firms have failed to live up to their investment and job creation agreements. They were not subject to any sanction or penalty by the state that would protect the public's investment. This is the equivalent of continuing to pay a vendor who has not yet provided a service.

Conclusion

The questionable application of EDIP tax credits undermines the intended purpose of the program and hinders true economic development. When established, the EDIP was intended to stimulate real economic growth but a lack of oversight and administrative controls makes it susceptible to abuse. Both DOR and DBT must immediately act to strengthen their oversight of these programs. A program that grants hundreds of millions of dollars in tax credits requires constant vigilance and rigorous administration. Businesses should not receive tax credits simply for the asking. DBT's proposed regulatory changes for the EDIP do not go far enough to address the need for program oversight.

Taxpayers deserve a return on their investment and it is up to DOR and DBT to ensure that they get this return. The EDIP and other economic development incentive programs is a public sector form of venture capital. Just as venture capitalists expect a return on their investments, so should taxpayers. In these tough budget times, the Commonwealth should ensure that incentives are put to good use.

DOR should immediately investigate the examples provided in this letter as well as other tax credit cases to ensure that the tax credits were lawful and that the recipients of these credits kept their promises to the Commonwealth. DOR should disallow credits taken under false pretenses and should seek to recoup these funds for the Commonwealth.

Please do not hesitate to contact me if you have any questions or concerns. This Office is prepared to assist you in these and other investigations. We look forward to working with you to ensure that the taxpayers of the Commonwealth are receiving a fair return on their investments.

Sincerely,

Gregory W. Sullivan
Inspector General

cc: Hon. Cynthia Stone Creem, Senate Chairperson, Joint Committee on Taxation
Hon. Paul C. Casey, House Chairperson, Joint Committee on Taxation
Hon. Marc R. Pacheco, Chairperson, Senate Post Audit & Oversight Committee
Hon. James H. Fagan, Chairperson, House Post Audit & Oversight Committee
Barbara Berke, Director, Department of Business and Technology
Members of the Economic Assistance Coordinating Council
Scott Brown, Executive Director, Office of Business Development
George Mazareas, Director, EDIP