CORRESPONDENCE/Memorandum

Date: October 7, 2020

To: Joel Brennan
Secretary, Department of Administration

From: Division of Executive Budget and Finance

Subject: Eligibility Determination for the Electronics and Information Technology Manufacturing Zone Credit Award

At your request, staff in the State Budget Office most familiar with the Contract and related tax-credit eligibility have provided background related to the factors that are weighed as to whether Foxconn has earned eligibility to receive tax-credit payments for their performance as set forth in their April Submissions. This question is material to our office's budgetary work. Our analysis and conclusions are summarized below.

Introduction

On November 10, 2017, consistent with 2017 Act 58, the Wisconsin Economic Development Corporation ("WEDC") entered into a public-subsidy agreement with three Foxconn affiliates — FEWI Development Corporation, SIO International Wisconsin, Inc. and AFE, Inc. — collectively designated as the "Recipients" in the parties' Electronics and Information Technology Manufacturing Zone Tax Credit Agreement (Contract #EITMZ FY18-23932) (the "Contract"). The Department of Administration played a supportive role in the pre-contract formation process leading up to the execution of the Contract, and has also been actively involved since in monitoring and assessing the Recipients' performance of the Contract and in communications and meetings with both WEDC and various representatives of the Recipients in regard to their performance with respect to the Contract. The Contract calls for annual determinations by WEDC as to the eligibility of the Recipients to earn tax-credit payments from the state for their performance of the project described in the Contract in the prior calendar year(s) as to job creation and capital investments per the terms and conditions in the Contract.

On April 1, 2020, the Recipients submitted their Performance Report and Tax Credit Workbooks ("the Workbooks") with Payroll and Capital Expenditure Forms (collectively the "April Submissions") as part of the verification process for WEDC to determine the Recipients' eligibility for job-creation tax credits for work performed during calendar year 2019 and capital expenditure tax credits for expenditures made during calendar years 2018 and 2019. The written instructions (the "Instructions") to the Workbooks provided by WEDC to the Recipients in advance of their April Submissions state that eligibility to earn tax credits under the Contract is limited to only those "Full-Time Jobs" created by the Recipients and "Significant Capital Expenditures" made in the "Zone" by the Recipients that directly pertain to construction and operation of the "Project", a Generation 10.5 TFT-LCD Facility located in the "Zone" (throughout this memorandum, the capitalized terms in quotes in this sentence and elsewhere in this memorandum have the meanings defined in the Contract). In their April Submission, the Recipients made no effort to comply with the clear Instructions or state any disagreement with their applicability. Instead, the Recipients' April Submission lists various jobs and expenditures having nothing to do with the required Generation 10.5 TFT-LCD Project.

Question Presented:

Is the project performance of the Foxconn Recipients detailed in their April Submissions eligible under the Contract to receive tax-credit payments from the state?

Brief Answer:

No. The Recipients' project performance does not satisfy the requirements of the Contract. Because none of the jobs or capital expenditures listed in the Recipients' April Submission relate to construction or operation of the contractually required Generation 10.5 TFT-LCD Project, none are eligible for tax credits under the Contract. Further, the new type of development activities that the Recipients have chosen to pursue are neither quantitatively nor qualitatively similar to the Project specified under the terms of the Contract.

Summary

The above conclusion is consistent with what WEDC's leadership and other senior representatives of the state have stressed to the Recipients orally and in writing over the past 16-plus months. We also are aware of no objection (either at the time or subsequently) by the Recipients to the correctness of the Instructions for the Workbooks WEDC provided to the Recipients prior to the Recipients' April Submissions. Staff also believes that, in addition to the overarching eligibility failing noted above, the Recipients fell short of the job minimum set in the Contract for the year ended 12/31/2019. To be counted as an eligible Full-Time Employee for the year claimed, the employee must have been paid regular employment compensation by 12/31 of the year being evaluated. That requirement eliminates a number of the jobs claimed in the Recipients' April Submissions. Additionally, the compensation paid by 12/31 must be at a rate, when annualized, of at least $30,000 (plus the benefits specified in the Contract). This requirement also eliminates a number of the claimed jobs in the April Submissions.

The Contract specifies an expectation that 2,080 people should have been employed at a Generation 10.5 TFT-LCD Project by 12/31/2019. The Contract sets the required minimum at 25% of that level; namely, 520 eligible Full-Time Employees. Staff believes that the Recipients fell short of that job minimum for 2019. They also missed the jobs minimum for the prior year, 2018.

Finally, staff notes that, as WEDC has previously stated, only the three Recipients that are parties to the Contract are eligible to seek tax-credit subsidies from the state for financial contributions made in the Zone. The three Recipients are the only Foxconn affiliates which applied in 2017 to WEDC, and were the only entities evaluated and certified by WEDC. The Recipients also were the only entities which provided guarantees to cover potential "claw backs" of credits under the resulting Contract. Hence, it merits mention that whatever financial contributions that Foxconn Industrial Internet ("FII") (which is not a party to the Contract) may have made to date as to the improvements in the Zone, including those that have been referred to by Foxconn and/or FII in media reports from time to time as the FII Data Center, the FII Smart Manufacturing Center, the FII Artificial Intelligence (AI) Institute and the FII Planning Center, are ineligible under the Contract. Should FII wish to apply for credits as to its future development activities, it would be required to follow the process outlined in the Contract which was explained to the Recipients in writing and orally over the past year and a half by WEDC and the state.

The Generation 10.5 TFT-LCD Project Requirement

The "Project" the Recipients committed to build and operate per their project Applications to WEDC and the Contract was, as defined at section 1-(o) of the Contract, a "Generation 10.5 TFT-LCD Fabrication Facility." It is undisputed that the Recipients have neither built, nor started to build or operate, the required Generation 10.5 TFT-LCD Fabrication Facility. Representatives of the state have determined that fact from their own observations and evaluations, from an industry expert hired to provide consulting services, and, in recent months, from the Recipients themselves, who have acknowledged that fact. Nor have the Recipients provided evidence that they have any specific formal business plans to build the promised Generation 10.5 facility in the Zone by 2025, the final year provided in the Contract for earning capital-expenditure credits.

Starting in March 2019 and continuing through to the Recipients' April Submission, WEDC and other representatives of the state, including the Secretary of DOA, repeatedly stressed to the Recipients orally and in writing that the Recipients were not eligible to earn tax credits under the Contract for business development activities different than the Generation 10.5 Project specified in the Contract. The Recipients were also repeatedly reminded that, if the Recipients wished for their activities in the Zone to become eligible, they first needed to negotiate amendments to the Contract that aligned the terms of the Contract with the reality of the Recipients' materially changing plans in a manner that fairly benefited both sides. Starting with former WEDC Secretary Mark Hogan in early 2019, the Recipients were informed that there is a process for seeking amendments which starts with new project applications being submitted which detail the specifics of the type of new business development activities the applicant(s) would like WEDC to evaluate and certify (See also Contract section 7-i, governing the process for amendment requests). Despite repeated and consistent communication from WEDC and the State regarding the necessary amendment process, the Recipients chose not to pursue the amendment opportunity prior to submitting their April Submissions.

The state's position about the contractually mandated Generation 10.5 TFT-LCD Project has never changed. Throughout the entire contract-formation period from June 2017 through to entering into the Contract on November 10, 2017, the parties focused exclusively on making the construction and operation of a massive Generation 10.5 TFT-LCD facility the "Project".

In the Spring of 2017, Foxconn shared a detailed Request for Proposals (RFP) with Wisconsin and several other states. The RFP laid out the potential that, in return for Foxconn's desired level of public subsidy, the company would construct and operate either or both a massive

Generation 10.5 TFT-LCF Facility (termed the "FAB 818" in the RFP materials) and/or a smaller Generation 6 type of facility (termed a "FAB 868" in the RFP materials). Wisconsin chose to support and subsidize only Foxconn's construction and operation of the so-called FAB 818 Generation 10.5 TFT-LCD facility described in the Foxconn RFP materials, and not the smaller Generation 6 FAB 868 type of facility.

The July 27, 2017 Memorandum of Understanding (the "MOU") for the project entered into by then Governor Walker for the state and then Chairman/CEO Terry Gou for the Foxconn entities memorialized the parties' commitment to basing the project on solely the FAB 818 Generation 10.5 TFT-LCD facility. According to the MOU, the intent of the parties was that the project would involve the "construction, start-up, and ongoing operations" of the FAB 818 Generation 10.5 TFT-LCD facility producing glass substrates (MOU p.1). The 3-page MOU mentions the FAB 818 Generation 10.5 facility nine (9) times. It does so in most every paragraph, and never mentions the alternative FAB 868 Generation 6 type of project, nor any other type of business development activities as being included in the agreement.

From the MOU forward, the entire contract-formation process focused exclusively on the Generation 10.5 TFT-LCD "Project". The Recipients' project Applications to WEDC focused exclusively on the Generation 10.5 facility, which the Recipients defined and explained in Attachment 3 to the Recipients' September 15, 2017 Application. Similarly, both WEDC's "Opportunity Recommendation Memo" dated 8/18/2017 and its later 11/07/2017 detailed "Staff Review" of the project signed as "approved" by the then 5 most senior officials at WEDC, mentions only the Generation 10.5 TFT-LCD facility as the business activity being underwritten and evaluated. The economic analyses by Ernst & Young and Baker Tilley used by proponents of the project to help justify its merits and the subsidy levels also focused expressly on the proposed Generation 10.5 TFT-LCD project and not any other type of alternative business development activities.

The Contract reflects this background and the parties' intent as set forth in the MOU. It specifically defines the Generation 10.5 TFT-LCD Facility as "the Project". The 4th recital to the Contract summarizes the overall deal as one in which the state promises to provide up to three billion dollars in subsidies "in exchange for [the Recipients] siting the Project in Wisconsin, making a capital investment of up to Ten Billion Dollars ($10,000,000,000) and creating up to thirteen thousand (13,000) Full-Time Jobs…" (emphasis added). Again, using the defined term "Project", the Contract requires the Recipients to do various things to carry out the "Project". See, e.g., Contract section 4-a, b, d and g. The Recipients have not sited a Generation 10.5 TFT-LCD project in Wisconsin and none of the jobs or capital expenditures listed in their April Submissions pertain to the required "Project". Therefore, none of the job and capital expenditure listings set forth in the Recipients' April Submission should be eligible to be subsidized at taxpayer expense.

The terms of the Contract affecting the state presumably would have been negotiated to be materially different than they are had there been a shared understanding that the Recipients could earn tax credits for any type of business activity of any scale or nature rather than the project specified and agreed to. The present mix of smaller scale development activities being pursued by the Recipients are described by the Recipients to be far more automated than the Generation 10.5 factory and are expected to generate far fewer Wisconsin jobs relative to the level of capital expenditures than the Generation 10.5 facility. As a result, application of the current Contract terms to such activities would result in a higher per-job cost to the state and less likelihood of such a project ever generating a net benefit to the state's taxpayers funding such subsidies.

The Recipients' decision to substantially change the scope and nature of their business-development activities in the Zone away from the agreed Project materially affects the state's interests in multiple respects. When the state decides to provide direct subsidies for any large project, it is in pursuit of furthering specific economic and policy objectives. It is not enough that an applicant offers to build some buildings and create some jobs. The state only has the resources to subsidize a fraction of the new developments and jobs created each year in the state. The goal of targeted economic-development subsidies is that they are crafted to advance specific state objectives such as building up a particular industry sector in a specific area of the state or enhancing a particular labor market segment or location. Those arrangements are also crafted to ensure that the state's taxpayers will receive a net benefit from the development, typically within the term of the agreement. When a developer contracts to pursue a specific development that the state has agreed in advance fits the state's objectives, the developer is not free to later switch the scale and nature of its development without amending the subsidy contract in advance in consultation with the state. The 15% and 17% investment and job subsidies offered by the state here as part of the EITMZ Contract are far higher than any other type of development subsidy ever offered by the state and were for a very specific type and nature of project that would advance specific objectives of the state. The total amounts of the available subsidies under the EITMZ Contract were also unprecedented. There would have been no need or justification for the state to offer such extraordinarily large subsidies for what the Recipients have now decided to pursue.

The relationship between the promised nature of the massive Generation 10.5 TFT-LCD Project and its effect on the interests of the state's taxpayers is reflected in all of the various analyses at the time. For instance, in the Legislative Fiscal Bureau's initial analysis of 2017 Wisconsin Act 58 and the Foxconn project (dated 8/21/21017) and its later analysis (dated 10/04 2017), LFB discussed DOA's analysis about when the proposed deal would have a "break-even" point (under the stated assumptions) by which year the deal would become positive for the state's taxpayers. DOA projected that the Generation 10.5 project might break even by 2042 if the Recipients' hired 13,000 full-time direct employees for the promised facility by 2021. LFB noted in both analyses, however, that, if the nature of the Project were to change such that the Recipients hired only 3,000 full-time direct employees at the facility by 2021, the project would not yield a net benefit for the state's taxpayers "until well past 2044-45" (8/21/2017 analysis at p.22 and 10/04/2017 analysis at p.27). WEDC contracts have historically always had a projected break-even point within the term of the contract. There would be no reason for the state to contract to provide business-development subsidies for activities without being able to demonstrate a reasonable "break-even" date by which the taxpayers paying the subsidies could be expected to benefit on a net basis.

The decision to locate the EITM Zone in the Village of Mt Pleasant based on the statutory requirement in Wis. Stat. 238.396 (1m)(d) that "to the extent possible, preference [should be given in the siting decision to the area in the state] of greatest economic need" made sense for the proposed massive Generation 10.5 facility projected to employ 13,000 area residents in largely blue-collar manufacturing factory jobs. However, the siting designation would have made less sense for a small highly automated facility employing mostly engineers and other white-collar professionals. The latter types of potential employees are unlikely to be unemployed or underemployed local residents in that area of the state looking for work and more likely to be residents commuting from nearby Illinois who would pay their state personal income taxes in Illinois, not Wisconsin. Similarly, it would have been highly unlikely that the state would have entered into the Moral Obligation Agreement on its present terms if the Recipients needed only to construct the modest level of improvements presently slated because a million to two million square feet of such improvements obviously is less likely than the 20 million square feet of improvements promised for the Generation 10.5 facility to cover the $1.4 billion valuation increment increase necessary to cover the TID-5 debt service. Finally, the present type of much smaller and more automated type of project would have needed far less costly state, county, and local investments in roadway, sewer, water, and other infrastructure improvements than the Generation 10.5 facility contracted for but no longer pursued by Recipients.

Recipients Are Off the Pace of Performance Contemplated by Their Project Applications and the Contract

In the Performance Report submitted as part of their April Submission, the Recipients acknowledged that they had invested only 2.8% of the total $10 billion contemplated by the Contract. According to their 11/07/2017 updated project Applications (see section 1-c of the Contract and Attachment 8 to the Applications), the Recipients had contracted on the basis that they would invest over $10 billion for the Project in the Zone and directly employ 13,000 Full-Time Employees by 2022. By the end of 2020 (just a few months from now), the Recipients' applications projected a total employment level of 5,200 Full-Time Employees and total investment of $6.27 billion in the Zone. Regardless of eligibility, they are not close to that pace of progress and have provided no evidence of specific formal plans to catch up.

From information the state is able to review, the level of the Recipients' employment in the state has likely dropped in 2020. That pattern is inconsistent with demonstrating any reasonable likelihood that they are on track to reach even the job minimums required for 2020. In addition, the pattern of hiring spikes at the year-end December job reporting deadline followed by drops in the following months also fails to meet the requirement in the Contract that the Recipients must "maintain" their employment levels for "180 consecutive months" starting January 2018 (Contract at section 4-c).

The building in the Zone sometimes referred to by the Recipients as their Generation 6 FAB is not similar to the Generation 10.5 TFT-LCD facility called for by the Contract. The facility referred to by the Recipients as a Generation 6 FAB is far smaller than even the type of facility described as a Generation 6 FAB 868 in Foxconn's original RFP, which WEDC chose not to subsidize. DOA's technical expert reports that the present "FAB" facility – if operational – would be the smallest Generation 6 operating anywhere in the world. It is less than one-twentieth the size of the promised Generation 10.5 Project and would employ — if it ever became fully operational — only a small fraction of the local residents who WEDC expected to be employed by the required Project and for whom the Zone was located in a specific Wisconsin county and community. The Recipients' new building also is not equipped to fabricate glass substrates, a key attribute of any true TFT-LCD "FAB" facility. The LCD glass technical expert consulted by DOA has advised that the building the Recipients have been describing in the media as a "Gen 6 FAB" is not a true TFT-LCD fabrication facility to manufacture ultra-thin glass substrates. It is not designed or equipped to fabricate TFT-LCD glass substrate panels; the expert reports that it appears to be a place equipped to perform some assembly operations, and may be better suited for demonstration purposes rather than as a viable commercial glass fabrication facility. The Recipients applied for and were granted a state permit earlier this year to use that building for storage at least temporarily rather than manufacturing, so it is off track to be considered a viable manufacturing facility for fabricating glass substrates of any size.

A Determination of Ineligibility Would Not Be Unfair to the Recipients

The Recipients abandoned the Generation 10.5 Project agreed to in the Contract for their own internal business reasons and switched to a project that is far smaller and materially different in nature than the expected Generation 10.5 Project. They did so without providing the formal advance notice to WEDC required by the Contract (see section 4-g-iv) and without seeking WEDC's formal written consent to the changes through timely amendments to the Contract. The Recipients' plans for the Zone have fluctuated over the past two years with minimal transparency.

State and local taxpayers have already provided significant support to the Recipients, in anticipation of the Project contemplated in the contract. Taxpayers fully performed their side of the agreement to date, while the Recipients have not.

Since the Contract went into effect, state and local taxpayers made large investments by providing job training, applying sales-tax exemptions, and building new roads and other infrastructure crafted in scale and type to fit the expectation that, as specified in both the Contract and the Development Agreement between the Recipients and the local units of Wisconsin government as to the Mt. Pleasant TID-5, the Recipients would be spending up to $10 billion on building a massive 20 million square foot LCD fabrication facility that would directly employ about 13,000 people. Even ignoring both the large financial commitment by the local taxpayers to the TID around the Zone and the several hundred million dollars state and federal taxpayers spent on the portion of the I-94 Interstate adjacent to the real estate transferred to the Recipients in the Zone, state taxpayers have spent as much if not more than the Recipients have spent to date on improvements in and around the Zone.

Those taxpayer funded costs have benefitted the Recipients by improving the value of the real estate transferred to the Recipients as part of the Development Agreement with the local units of government, which also specifically requires Foxconn to build the Generation 10.5 Project. Given the low levels of employment in the Zone to date, it seems unlikely that Wisconsin taxpayers will ever see a net benefit as to even these upfront costs. Moreover, the Recipients' unilateral decision to build a much smaller and drastically different project than the one specified in both the Contract and the Development Agreement increases the financial exposure of the state's taxpayers to make future payments on the Moral Obligation Agreement.