

**House Committee on Economic Revitalization, Business, and Military Affairs and
Senate Committee on Economic Development and Technology
Joint Info Briefing on Act 221 • Wednesday, January 28, 2009**

Legislators in Attendance:

EDT

Chair/Senator Carol Fukunaga
Vice-chair/Senator Rosalyn Baker
Senator David Ige
Senator Sam Slom

EBM

Chair/Representative Angus McKelvey
Vice-chair/Representative Isaac Choy
Representative Joey Manahan
Representative Clift Tsuji
Representative Glenn Wakai
Representative Jessica Wooley
Representative Gene Ward

AGENDA

1. Overview of Hawaii's Tech/Diversified Economy — *Lisa Gibson, Hawaii Science and Technology Council (refer to powerpoint presentation).*

2. Discussion of the Benefits of Act 221 — *David Watumull, Cardax Pharmaceuticals (refer to powerpoint presentation)* introduced the following proponents of the benefits of Act 221:

- ***Henk Rogers, Blue Planet Software*** (provided background on use of Act 221 by his videogames/digital media companies).
- ***Reb Bellinger, Makai Ocean Engineering*** (provided background on use of Act 221 by his dual-use company).
- ***Jason Lau, TalkStory Productions LLC*** (provided background on use of Act 221 for film/media projects produced by his company).
- ***Darren Kimura, Sopogy*** (provided background on use of Act 221 by his renewable energy businesses).

In summarizing the ways in which Act 221 has helped these types of tech businesses, Mr. Watumull noted that it is hard for qualified high technology businesses (QHTB's) to be profitable because ACT 221 requires that 50% of the tech company's operations must be dedicated to research.

3. Discussion of the Disadvantages of Act 221 — *Linda Smith, Senior Advisor for Governor Lingle (refer to powerpoint presentation)* outlined the features of the Lingle administration's bills to modify several features of Act 221.

- HB1157/SB 975 would cap the aggregate amounts of tax credits that could be used between July 1, 2009-December 31, 2010 at \$160 million (or roughly \$80 million per year).
- ***Lowell Kalapa, Tax Foundation of Hawaii*** discussed the lack of accountability for the benefits of business tax credits at a time that state tax revenues are falling. Mr. Kalapa believes that use of the low-income housing credit can be distinguished from use of Act 221's high-tech credits, in that he believes that there is greater transparency in the use of low-income housing credits.

4. Discussion of Pros and Cons regarding Act 221 Tax Credits

- **Question:** **Senator Fukunaga** asked about the administration's concerns with specific costs of ACT 221 credits, and whether the administration has any alternatives other than the tech credits to boost Hawaii's economy.
- **Response:** **Mrs. Smith** said the administration supports placing some parameters around ACT 221 tax credits to catalyze the industry in becoming more competitive. She

suggested the creation of a board to weigh the benefits of two proposals under consideration by the Department of Taxation.

- **Question: Senator Fukunaga** asked proponents of Act 221 whether they believed that modifications to ACT 221 credits would yield savings of tax revenues.
- **Response: Jeff Au, PacifiCap Group LLC** said he believes that the state's budget issues are significant; however, there are better solutions than messing with ACT 221. Example: he pointed out that Department of Taxation has reported uncollected, delinquent taxes of roughly \$1 billion per year. Even if you collected a percentage of that, it would be beneficial. Technology can solve these problems; for example, more efficient deposits of checks can be done with a technology fix.

Response: Director Kawafuchi indicated that he is well aware of delinquent taxes; and the department has legislative and administrative initiatives to address this problem. Mr. Kawafuchi noted that one of the administration bills would address the 'cash economy'. He said his department is focusing on monetizing 'as much delinquent taxes as possible'.

- **Question: Representative Tsuji** asked Mrs. Smith to explain the differences between use of low-income housing credits vs. high-tech credits. For example, if a housing project falters, there's a provision saying that the tax credit becomes a loan payable to the investors if the project is not completed. What type of guarantees can you provide if the tax credit isn't being used for a successful high-tech business?
- **Response: Mrs. Smith** pointed out that only reason the administration had brought up the use of low-income housing credits was because Mr. Kamikawa had said (during the January 20, 2009 briefing) that ACT 221 credits were modeled on the state's low-income housing credits. If a developer wants to convert a low-income housing project to a luxury housing project, he can't write this project off; it will become a loan payable from the developer back to the investors.
- **Question: Representative Tsuji** asked whether Governor Lingle's proposed allocation of \$100 million for venture capital investments within the ERS investment portfolio still holds true. *NOTE: 2008 legislation to authorize the \$100 million allocation was not adopted.*
- **Response: Mrs. Smith** stated that the administration prefers to have the State's ERS system invest in local companies rather than investing in companies on the mainland. Example: Chile used investments from its pension funds in the 1980's to create industries in their country. Fruit shipment industries and aquaculture industries were created because Chile was willing to use its funds to invest in solid companies, and expanded its economy.

Response: Mr. Kalapa responded that ACT 221 tax credits should be modeled on low-income housing tax credits (e.g., with same provisions for disbursement by a government agency over a 10-year time frame).

Response: Mr. Steinmark said that he served on a housing board that evaluated low-income housing projects. They had tried to lower costs of homes but made slow progress. This group concluded that, if they were going to solve the housing problem, they would need to raise citizen's income levels, or the gap will continue to widen.

- **Question: Senator Baker** asked how the administration proposed to grow Hawaii's economy. If the state is not attracting investment, what is the administration's proposal for growth besides raising fees and taxes?
- **Response: Mrs. Smith** said that the administration has a five-point plan to position the state for growth in future: by investing in broadband, renewable energy, the construction

industry, tourism, and increasing food self-sufficiency is the right counterpoint to stabilize the economy.

- **Question: Representative McKelvey** asked whether, under the administration's current proposal to make changes to ACT 221 credits, would companies such as Kahe'awa Wind Power be disqualified from being able to use these tax credits?
- **Response: Director Kawafuchi** stated that it would depend on that company's level of experimentation and innovation in its respective industry.

Response: Mrs. Smith pointed out that these facilities (such as Kahe'awa Wind Power) are generating revenue today. Investors will look at this, and determine whether or not they want to invest. If it's cutting-edge tech, you use ACT 221 kinds of credits; if you have more mainstream tech, those will attract the kind of money that they need.

- **Question: Senator Ige** asked about the Governor's comments regarding limiting/eliminating credits for performing arts projects. Is limiting these kinds of investments in the administration proposals?
- **Response: Director Kawafuchi** explained that the administration has two ACT 221 proposals: the proposal with a cap will not affect performing arts products, but performing arts applicants would have to apply for use of the ACT 221 credits. Under the second proposal, performing arts products will not be eligible to use ACT 221 credits.

Response: Bill Meyer, Entertainment Attorney pointed out that, once a digital media company matured, it would have to move out of Hawaii because the ACT 221 incentive would not apply to Hawaii. In his view, modifying the ACT 221 credits to follow Internal Revenue Code Section 41d would throw just about everything out from ACT 221's scope - biotechnology, aquaculture, ocean sciences, etc. Companies would likely have to migrate out-of-state. **Donovan Ahuna, IATSE, Local 665** agreed that use of ACT 221 credits for film/media projects has helped create good-paying jobs for Hawaii residents.

- **Question: Representative Ward** asked how the administration expects to save money if you don't generate money.
- **Response: Mrs. Smith** said that the two administration bills recognize that state doesn't have open pocketbook. The administration believes that using an aggregate cap over next 16 months at \$160 million is reasonable. Companies that aren't high-tech in nature will not be able to claim ACT 221 credits.
- **Question: Representative Wooley** asked whether there is a distinction between start-up businesses and small businesses, and those that are very large profit-wise.
- **Response: Jeff Au** stated that 78.5% of QHTB companies have been reported as not being profitable in the Department of Taxation's reports. ACT 221 was to provide companies the capital to survive. Companies that are already profitable do not use ACT 221 because use of the credit dilutes the ownership of the company.
- **Question: Sen Slom** asked what the estimated total tax income from Act 221 companies is.
- **Response: Director Kawafuchi** stated that he doesn't know answer right now; and will have to get back to the committee.
- **Question: Sen Fukunaga** asked Director Kawafuchi to specify what it would take to get this kind of information. The department's responsibility is to gather information on the taxes generated by expenditures made by ACT 221 businesses.

- **Response: Senator Slom** asked whether Department of Taxation could talk to DBEDT to get this information. He also asked Department of Taxation whether it accepted the numbers posed by ACT 221 proponents David Watumull and Jeffrey Au?

Response: Director Kawafuchi said that the department's reports showed that QHTB businesses received \$1.2 billion in investments (2002-2007). The 'costs' of ACT 221 credits to the State is about \$657 million (based on eligible investors claiming a full five years' worth of ACT 221 credits). The department needs to factor in what is expected over the next few years in terms of people claiming this credit. If ACT 221 remains the same, we have to calculate the costs of future credits being claimed for each year's investments.

Response: Jeff Au said that the legislature should not put a statutory limit on ACT 221 because there are market limits that will effectively control use of the credits.

A major limitation is tax liability: investors do not have that much tax liability; therefore they do not have that much to invest. At 8.5% marginal rates, in order for someone to invest \$100,000, they need to accrue \$1.2 million in taxable Hawaii net income. Even though ACT 221 credits are viewed as generous, investors want companies that will generate the highest returns. Limits on usage are now imposed by market forces.

- **Question: Representative Wakai** asked proponents to quantify how much \$ actually trickles down to a QHTB? If company gets a million in investments, how much goes to fees (for attorneys, venture funds, etc.)?
- **Response: Bill Spencer, Hawaii Venture Capital Association** pointed out that companies do not get tax credits, investors get tax credits. However, all of the money invested essentially reaches the QHTB.

4. Discussion on the future of Act 221 — Bill Spencer, Hawaii Venture Capital Association summarized points raised during the question/answer period, highlighted his own ACT 221 start-up (ocean-based aquaculture project) and introduced the following presenters:

- Steven Loui, Navatek CEO
- Mealani Parish, Navateck Mechanical Engineer
- Scott Yamashita, Navatek Hydrodynamic Engineer

The final presenters noted that the kinds of high-quality jobs they are creating in companies like Navatek represent Hawaii's future with ACT 221 - quality jobs for Hawaii residents.