

NEIL ABERCROMBIE
GOVERNOR

BRIAN SCHATZ
LT. GOVERNOR



STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1540
FAX NO: (808) 587-1560

FREDERICK D. PABLO
DIRECTOR OF TAXATION

RANDOLF L. M. BALDEMOR
DEPUTY DIRECTOR

LATE TESTIMONY

January 25, 2012

To: The Honorable Angus L. K. McKelvey, Chair
and Members of the House Committee on Economic Revitalization and Business

Date: Thursday, January 26, 2012

Time: 8:30 a.m.

Place: Conference Room 312, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. No. 1511 Relating to High Technology

The Department of Taxation (Department) has concerns over this measure.

This measure would retroactively reinstate the tax credit for research activities, as well as to increase the amount of the credit by an additional ten percent (10%) for “qualified labor costs”, which is defined as costs “that are attributable to wages or salaries paid by the qualified high technology business for the first twelve months of employment of any full-time employee or any part-time employee who is also full-time student, and who is a resident of the State of Hawaii”.

The Department first notes under the federal regulations governing the research credit, the credit already includes direct labor, certain support labor, and certain supervisory labor. It is not clear whether the intent of the measure is to provide that the qualified labor cost is in addition to the amounts that are already eligible to be claimed, or if only labor which is not currently eligible for the credit is eligible for the additional amount of the credit. If the latter, the Department would have to review the credit claims to insure that the labor costs are not claimed twice.

The definition of qualified labor costs would include the amounts paid to anyone employed by the high technology business, and thus include janitors, accountants, and other non-research personnel. The inclusion of “qualified labor costs” can create incentives for the company to manipulate the system. For example, because there is no requirement for the labor to be connected to the to the qualified high technology business, a company that has multiple lines of business could simply run the payroll through the qualified company in order to obtain the benefit of the credit. In addition, the lack of a limit on the amount of compensation subject to the credit could lead owners to pay inflated salaries to spouses and children far in excess of what might otherwise be deemed to be a reasonable salary. Because there is no on-going requirement that the employee continue to be in the employ of the company, a company can effectively terminate all its staff after a year, rehire them or replacements, and continue to obtain the benefits of the credit.

Department of Taxation Testimony
ERB HB1511
January 26, 2012
Page 2 of 2

Also, broad definitions for "research" and "supply" have made it difficult for the Department to administer the credit, resulting in protracted complex litigation. The litigation over which expenses are eligible for the credit has required the Department to expend considerable resources to hire outside experts on this matter.

The Department also, notes that the retroactive date of the bill would have a fiscal impact on the current year's budget since it is a refundable credit.

Thank you for the opportunity to provide comments.



**Testimony to the House Committee on Economic Revitalization & Business
Thursday, January 26, 2011 at 8:30 a.m.
Conference Room 312, State Capitol**

RE: HOUSE BILL NO. 1511 RELATING TO HIGH TECHNOLOGY

Chair McKelvey, Vice Chair Choy, and Members of the Committee:

The Chamber of Commerce of Hawaii ("The Chamber") **supports the passage of HB 1511** relating to High Technology for further discussion.

The Chamber is the largest business organization in Hawaii, representing more than 1,100 businesses. Approximately 80% of our members are small businesses with less than 20 employees. As the "Voice of Business" in Hawaii, the organization works on behalf of its members, which employ more than 200,000 individuals, to improve the state's economic climate and to foster positive action on issues of common concern.

HB 1511 establishes a tax credit for 10% of qualified labor costs; extends the tax credit for qualified research activities for five years.

This bill will create and retain jobs while increasing the state's revenues. We cannot afford to overlook the prime opportunity to promote this growing sector in our state. This is the opportune time to support our small local companies in the R&D industry so that it can continue to flourish and provide jobs for our talented citizens and ensure that our talented keiki have a viable option to move back or stay in Hawaii and obtain quality jobs. Furthermore, this measure will strengthen the industry's effort to compete with other players in the national and international arena. Finally, supporting the R&D industry will help broaden and diversify Hawaii's economic base.

Research and development is a highly critical component to a sustainable economy. R&D provides well-paying jobs to highly-educated employees. These employees pay significant taxes back to the state and spend considerable amounts of income within the state for goods and services. Furthermore, as the R&D matures it creates product companies that increase the number of jobs and tax base significantly.

Therefore, we respectfully ask that the committee to **pass this measure** for further discussion. Thank you for the opportunity to provide testimony.



126 Waihili Place
Honolulu, Hawaii 96825

T 808-352-0553

remington@continuum-icon.com

www.remingtonscott.com

LATE TESTIMONY

January 25, 2012

Committee on Economic Revitalization & Business
House of Representatives
Conference Room 312
State Capitol
415 South Beretania Street

Dear Committee on Economic Revitalization & Business,

Aloha. Please find my support for HB1511.

My work has received the Academy Award for Achievement in Visual Effects for the films *The Lord of the Rings: The Two Towers* and *Spider-man 2*. Both films utilized advanced technologies for which I have invested years fine tuning in research and development of performance capture and digital acquisition methodologies. *The Lord of the Rings* received the Academy Award for "utilizing a motion capture system to create the split personality character of Gollum and Smeagol", of which I was the Supervisor of Motion Capture. I have authored several patents, all of which have been possible because of time invested in R&D. One of my patents is used for the creation of the photo real facial performances by the digital characters in the blockbuster movies *Avatar*, *Rise of the Planet of the Apes*, *Tin Tin*. Directors such as James Cameron and Steven Spielberg have been able to tell these new stories, in large part, due to the vast amount of R&D that has made the technology possible.

My company, Continuum Icon, based in Honolulu, is set to bring about a new watermark of high technology and high profile computer graphics to the entertainment arena. However, to break ground and develop something that is completely unique takes a lot of time and energy in research and development, of which I have already invested almost a year of my time for Continuum Icon. Unlike just about any other industry, the high technology industry can not survive or thrive unless there is something compelling that is different, new or 'out of the box'.

Research and development in high technology industries elevate 'ideas' into 'events'. The cost of R&D is higher than ever in today's highly competitive technology markets as we must find new ways to achieve our goals or we will not stand out from the rest.

To put it succinctly, technology, in its definition is about the application of scientific knowledge for practical purposes. Understanding *how* to apply such knowledge is the direct result of research and development.

I'm committed to growing with Hawaii and hope you can pass HB1511 to help business like Continuum Icon realize their goals of leading the future rather than following the pack. Mahalo.

Sincerely yours,

Remington Scott

Partner, Continuum Icon



**The Chamber of
Commerce of Hawaii**
Since 1850

LATE TESTIMONY

**Testimony to the House Committee on Economic Revitalization and Business
Thursday, January, 26, 2012
8:30 AM
Conference Room 312**

RE: HOUSE BILL NO. 1511 RELATING TO HIGH TECHNOLOGY

Chair McKelvey, Vice Chair Choy, and members of the committee.

My name is Charles Ota and I am the Vice President for Military Affairs at The Chamber of Commerce of Hawaii (The Chamber). I am here to state The Chamber's support of House Bill No.1511, Relating to High Technology.

The measure proposes to establish a tax credit for ten percent of qualified labor costs, and to extend the tax credit for qualified research activities for five years.

The Chamber's Military Affairs Council (MAC) serves as the liaison for the state in matters relating to the U.S. military and provides oversight for the State's multi-billion dollar defense industry.

We concur with the comments stated in Section 1 of the proposed bill that opines that research and development is the core of innovation, and the essential foundation of steps needed to diversify Hawaii's economy through innovation and create gainful jobs for the workforce. It is the start to enabling Hawaii's emerging high technology sector to successfully compete with national and international businesses and economies.

Hawaii has been reliant on the tourism and defense industries to sustain economic growth. However, both are mature industries that have limited growth potential and will not contribute towards diversifying our economy.

R&D and innovation offer the potential to add another sorely needed pillar to Hawaii's economy, one that would create new businesses and spin offs that will benefit growth throughout our economy.

We concur with the premise in the first sentence of Section 1, R&D "... is the core of innovation, and without innovation there is no technology industry and the subsequent growth of our economy is stunted with no new products, services, or processes." Hawaii needs to establish a firm foundation to enable growth in high technology businesses.

Innovation will enable our brightest and adventurous generation to elevate Hawaii as a global leader in product development, manufacturing, and other related ventures.

Please note that Hawaii is the home base for a significant number of US military commands, to include combat forces of all of the service branches, world-class testing and development sites, and the Pearl Harbor Naval Shipyard. These military assets provide a unique opportunity to aid in establishing an ecosystem essential to sustaining growth in innovation.

In light of Hawaii's unique opportunity to diversify the economy, the MAC strongly recommends that House Bill 1511 be approved for further discussion and passage.

Thank you very much for the opportunity to testify.

LATE TESTIMONY

ALAN S. HAYASHI

207-4 Kawaihae Street

Honolulu, Hawaii 96825

TESTIMONY TO THE HOUSE COMMITTEE ON ECONOMIC REVITALIZATION AND BUSINESS

Thursday, January 26, 2012 @ 8:30 am

Conference Room #312

RE: HB 1511 "RELATING TO HIGH TECHNOLOGY"

Chair McKelvey, Vice Chair Choy and members of the ERB Committee:

My name is Alan Hayashi and I am testifying as an individual employed by a large defense contractor involved in research and development. My testimony is in support of the intent of HB 1511.

The High Technology industry's research and development (R&D) function is one that could employ Hawaii's brightest and best STEM graduates and could grow to be a substantial contributor to the kind of green "clean" economy we are striving to develop. Unfortunately, the 2008 economic downturn and corresponding lack of funding for research and development dealt a severe blow to the High Technology industry and the local technology community. The suspension last year of the R&D Tax credit was crippling to many small R&D firms. Some were sold to "off island" interests, and some severely cut back on employees, or closed. Because the industry is based on invention and innovation of intellectual property, firms are transportable....large factories are not necessary. Many sections of the country offer incentives to attract high technology industry to their cities. As such the competition for high technology companies is always present. Many stay in Hawaii, because they grew up here and enjoy the life style and closeness of family. However, in these competitive times, that is not enough. Unless Hawaii offers a competitive economic environment many will leave and the dream of a society of smart young folks solving problems and innovating will forever disappear.

If the Legislature values the High Technology capability, I urge you to support the industry with reinstatement of a tax credit.

Thank you for consideration of my position on the issue and for the opportunity to present testimony. I will be glad to answer and questions you might have.



**LATE
TESTIMONY
Bill No. s/b
HB1511**

Written Testimony of

James P Karins, PhD
President, Pukoa Scientific
before the

HOUSE COMMITTEE ON ECONOMIC REVITALIZATION AND BUSINESS

January 26, 2012

8:30 AM

State Capitol, Conference Room 312

In consideration of
HB 1642 RELATING TO HIGH TECHNOLOGY

Chair McKelvey, Vice Chair Choy, and Members of the Committee on Economic Revitalization and Business:

Pukoa Scientific supports this bill with Amendments. Pukoa Scientific recommends eliminating the year-over-year increase requirement and recommends the tax credit be rebated to companies without tax liability if this measure is designed to encourage small R&D companies to develop their products in Hawaii.

Pukoa Scientific is a small 5 person company located in the Manoa Innovation Center. Pukoa specializes in image processing for the defense, security, and home markets.

This bill will create and retain jobs while increasing the state's revenues. We cannot afford to overlook the prime opportunity to promote this sector which has been hit very hard over the past year. This is an opportune time to support our small local companies in the R&D industry so that they can flourish and provide jobs for our talented citizens and ensure that our keiki have a viable option to move back or stay in Hawaii and obtain quality jobs. Furthermore, this measure will strengthen the industry's effort to compete with other players in the national and international arena. Finally, supporting the R&D industry will help broaden and diversify Hawaii's economic base.

Role of the Research and Development Industry in Hawaii

The R&D technology industry can and will play a vital role in stabilizing the state's economic climate. One of the best ways for the industry to help is to maintain and grow the workforce. Without job creation, cost cutting and tax increases will only create a downward spiral, requiring more costs and more tax increases. The state must maximize its return by spending money that generates multiples of increased spending, garnering the most return from the least amount of tax dollars.

Research and development is one of those areas. In comparing the R&D tax credit to other credits, we observe that the R&D tax credit is one of the most effective in generating and maintaining jobs per tax dollar, generating higher tax revenues for dollar spent, and stimulating measurably more economic activity in the state per dollar of tax credit. Additionally, companies leveraging the R&D tax credits tend to be more mature companies; many on the cusp of significant expansion, which will accelerate the hiring of new employees and concomitant tax revenue.

Additionally, research and development is a highly critical component to a sustainable economy. R&D provides well-paying jobs to highly-educated employees. These employees pay significant taxes back to the state and spend considerable amounts of income within the state for goods and services. Additionally, as the R&D matures it creates product companies that increase the number of jobs and tax base significantly.

Some important facts related to R&D tax credits are:

- (1) R&D employees are highly paid and pay income taxes at high rates and generate significant other economic activity within the state. For example, the average salary for technology jobs is \$66,000.
- (2) R&D funds are highly leveraged by imported monies, thus generating more economic activity than economic activities that just move money from one in-state entity to another,
- (3) R&D tax credits are only received after the company has expended the funding, generating tax revenues to the state first,
- (4) R&D tax credits typically go back into additional R&D through additional salaries,

While these positive aspects are fairly defined, some have expressed concerns about the competitiveness of Hawaii's R&D tax credit levels and their refundability. However, several factors that are not considered in those concerns include:

- (1) Comparisons are only made to other states and not to other countries. R&D is becoming a economic driver worldwide and Hawaii companies compete worldwide,
- (2) The entire cost of doing R&D is the most important factor. Hawaii has a number of competitive disadvantages such as high income tax rates, high cost of living, high unemployment insurance costs, and high transportation costs, and
- (3) R&D returns are highest after several years when R&D turns into products, resulting in significant growth in job opportunities, increased intellectual property owned by Hawaii residents, and increased travel to the state by customers and technology related conferences.

Summary

In summary, the Hawaii R&D tax credit has been effective in generating new taxes, creating new companies and employing a number of residents. Therefore, it is important that a gap does not exist in the R&D tax credit while the administration and legislature addresses the longer term impact of R&D on the state. Companies need to make long term plans when doing R&D. It is critical to the industry that the tax credit be in place long enough to encourage R&D and its commensurate high paying jobs, job growth, and its direct impact on the sustainability of the state's economy.

Therefore, we urge the committee to **pass this measure with amendment**. Thank you for the opportunity to express our views.

Thank you for allowing me to testify,

James P. Karins, PhD
Karins@pukoa.com
(407)694-4485