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To: The Honorable David Y. Ige, Chair
and Members of the Senate Committee on Ways and Means

Date: Thursday, March 29, 2012

Time: 9:00 a.m.

Place: Conference Room 211, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. 1551, H.D. 2, S.D. 1 Relating to Tax Credits

The Department of Taxation (Department) appreciates the intent of this measure and provides the following comments.

H.B 1551, H.D. 2, S.D. 1 defines "qualified high technology business" to mean a business employing or owning capital or property, or maintaining an office, in this State; provided that more than fifty per cent of its total business activities are qualified research and more than fifty per cent of its qualified research is in this State. This bill also adds reporting requirements to measure the effectiveness of the tax credit for research activities, establishes a fine for failure to file the survey information in the reporting requirements, includes federal and state income tax returns and documents related to deductions for tax credits for research activities to be filed as part of the survey, and extends the tax credit through 2016. If passed the measure applies to tax years beginning after 12/31/2011.

The Department would first note that due to the elimination of the requirement that qualified research be performed in Hawaii (provided that at least 50% of the total qualified research was done in Hawaii) means that Hawaii taxpayers could end up paying for the entire cost of research done throughout the United States without any direct benefit to Hawaii. For example, a company that had offices both in California and Hawaii would be able to claim the credit on all qualified research costs, provided that the Hawaii office performed just over 50 percent of the qualified research.

As a refundable credit, the tax credit is more appealing to taxpayers; the federal tax credit is

nonrefundable. The Department is concerned about the potential revenue impact that this measure may have, due to the fact that there is no upper limit to the amount a company may claim.

In the past, broad definitions for "research" have made it difficult for the Department to administer the credit and resulted in protracted and 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. In addition, the Department is embroiled in litigation over whether a not-for-profit entity is entitled to claim the credit. The vagueness of what constitutes qualified research will attract even more companies.

The use of the term "business activities" also creates a daunting challenge for the Department. Exactly what constitutes a business activity is open to interpretation. For example, if a company is primarily an investment company but has a small research office, should it qualify as a research company because it does not consider its investment activities to be a business activity?

Likewise, the Department would note that a company whose activities are only 25% conducted in Hawaii would be a qualified company, since the measure only requires that a company do 50% of its business activities in Hawaii in qualified research. Thus a company that does 50% of its activities in non-qualified matters outside of Hawaii but does at least 50% of its activities in research would qualify, so long as 50% of that qualified activity was done in Hawaii.

While qualified research does not include research funded by a federal grant, the issue of whether a project is funded or not, is complex and litigation prone. In addition, funded and non funded research projects often overlap, with no clear distinctions on where one ends and the other begins. The Department believes that abuse of this credit can be mitigated by making the credit non refundable.

Lastly, the measure requires that a business claiming the credit is required to submit a report to the Department; based upon the reports, the Department would be required to report to the legislature on the effectiveness of the tax credit under this section. The Department would note that it has neither the staff, nor the expertise, to evaluate the effectiveness of the tax credit

Thank you for the opportunity to provide comments.



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Written Statement of

KARL FOOKS
President

Hawaii Strategic Development Corporation
and

Yuka Nagashima
Executive Director and CEO
High Technology Development Corporation

before the

SENATE COMMITTEE ON WAYS AND MEANS

March 29, 2012

9:00 PM

State Capitol, Conference Room 016

In consideration of

HB1551 HD2 SD1 RELATING TO TAX CREDITS.

Chair Ige, Vice Chair Kidani, and Members of the Committee on Ways and Means:

The Hawaii Strategic Development Corporation (HSDC) and the High Technology Development Corporation (HTDC) respectfully submit comments on HB 1551 HD2 SD1. We strongly recommend HB 1551 HD2 SD1 be amended to restrict the credit to only qualified R&D activities that are conducted in-state. HB 1551 HD2 SD1 appears to provide a refundable tax credit for R&D activities conducted out-of-state in addition to in-state expenditures. If the credit can only be claimed for actual expenditures made in Hawaii and only for 20% of the qualified expenditures, the cost of the program is partially offset by taxes collected on expenditures and payroll.

The state tax credit for research activities sunset at the end of calendar year 2010. This tax credit program was an effective measure to support research and development activities, which in turn, foster and encourage the innovation essential to the creation high-wage job opportunities in our economy. Over the life of the previous tax credit, the tax credit claims under this program averaged approximately \$11 million a year. It is anticipated that use of this credit may fall below this average as Federal spending on research activities has been reduced due to the elimination of earmarks.

HSDC and HTDC support efforts to reinstate this tax credit and support the addition of requirements to collect metrics from companies claiming the credit, as this will provide the data needed to measure the effectiveness of the credit.

Thank you for the opportunity to submit testimony on this bill.



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Thank you for the opportunity to submit testimony on this bill.