

**HB 1642**

**HD2, SD1**

# TAXBILLSERVICE

126 Queen Street, Suite 304

TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

**SUBJECT:** INCOME, Extend tax credit for research activities

**BILL NUMBER:** HB 1642, SD-1

**INTRODUCED BY:** Senate Committee on Economic Development and Technology

**BRIEF SUMMARY:** Amends HRS section 235-110.91 to require a qualified high technology business that claims the credit under this section to complete and file with the director of taxation, through the department website, an annual survey on electronic forms prepared and prescribed by the department. Requires the survey to be filed before June 30 of each year following the calendar year in which the credit may be claimed under this section.

The survey shall include: (1) identification of the industry sector in which the qualified high technology business conducts business; (2) qualified expenditures; (3) revenue and expense data; (4) Hawaii employment and wage data including the number of full and part-time employees retained, new jobs, temporary positions, external services procured by the business, and payroll taxes; and (5) filed intellectual property, including invention disclosures, provisional patents, and patents issued or granted.

The department of taxation shall use this information to prepare summary descriptive statistics by category. The information shall be reported at the aggregate level to prevent compromising identities of qualified high technology business investors or other confidential information. The department shall also identify each qualified high technology business that is the beneficiary of tax credits claimed under this section. The department shall report the information required under this subsection to the legislature by September 1 of each year.

Requires the department to use the information collected to study the effectiveness of the tax credit under this section. The department shall report on the amount of tax credits claimed and total taxes paid by qualified high technology businesses, the number of qualified high technology businesses in each industry sector, jobs created, external services and materials procured by the businesses, compensation levels, qualified research activities, and other factors as the department determines. The department shall report the results of its study to the legislature by December 1 of each year.

Amends the definition of "qualified high technology business" to mean a business that conducts more than \_\_\_% of its activities in qualified research.

Extends the expiration date of the tax credit for research activities from December 31, 2010 to December 31, 2015.

**EFFECTIVE DATE:** July 1, 2050; applicable to tax years beginning after December 31, 2010

**STAFF COMMENTS:** The legislature by Act 178, SLH 1999, and Act 221, SLH 2001, enacted various tax incentives to encourage the development of high technology businesses in the state. These acts provided

investment and research credits, as well as income exclusions, providing tax incentives to encourage high tech businesses and individuals associated with high tech businesses to locate in the state. This measure adds extensive information reporting requirements and extends the expiration of the tax credit from December 31, 2010 to December 31, 2015. While the adoption of this measure would allow the department of taxation to ascertain the effectiveness of the tax credit for research activities, such a review should have been performed a few years after the credit had been adopted.

While the proposed measure would also extend the credit for research activities until December 31, 2015, it would perpetuate the drain on state funds. It should also be remembered that the research credit is a refundable tax credit. Thus, should the amount of the credit exceed the taxpayer's income tax liability, any excess credit is a cash payment out of the state treasury to the claimant.

While the focus on high technology in the last few years is commendable, it fails to recognize that investments are made with the prospect that the venture will yield a profit. If the prospects for making a profit are absent, no amount of tax credits will attract investment from outside Hawaii's capital short environment. People do not invest to lose money. It should be remembered that until Hawaii's high cost of living can be addressed, all the tax incentives in the world will not make a difference in attracting new investment to Hawaii. The only attractive aspect for resident investors to plough money into such activities is the fact that the credit provides a way to avoid paying state taxes.

A former Hawaii resident who has been a success in the field of high technology pointed out recently what will make Hawaii conducive to high tech businesses and they are: (1) entrepreneurs, not capital, that comes first; (2) entrepreneurs coming from engineering schools and technology companies; (3) building a world class engineering school in Hawaii; (4) supporting internships at technology companies; (5) allowing our best children to go away to get a worldwide perspective; (6) not broadband passing through Hawaii that is a selling point; (7) that people fly direct and therefore is Hawaii's location in the middle of the Pacific an advantage?; (8) learning the rules of the game; (9) looking at Israel and learning from them; and (10) doing your own thing, being a copy cat does not work. At the heart of his remarks was the fact that in order to produce a high technology industry in Hawaii, those companies need to have access to institutions of higher education that are producing the people needed by the high technology industry. Without the academic synergy, Hawaii will never become a center for high technology activity. Thus, all of the tax incentives, like this measure embodies, will fall short of luring high technology firms to Hawaii.

Further, the tremendous tax burden, the draconian regulatory environment, and the dramatic increase in fees that go with the permitting process make Hawaii an unattractive place to do business. It should be remembered that while the high technology credits may look like a good incentive or enticement to undertake research activities in Hawaii, those who would conduct this research must live in the same high cost-of-living environment with which other taxpayers continue to struggle. Thus, the cost of maintaining those researchers will be higher than to do so where the cost of living is much lower. Let's not bet the farm on high technology without really understanding what makes this industry tick.

Obviously the authors of this proposal would like to ignore the evaluation of these tax incentives done by UHERO a few years ago which basically condemned the credits as a waste of state resources as there is little evidence that the current program of tax credits has created substantial new employment or on-going enterprises. It is truly amazing that given the dire condition of the state's financial condition that lawmakers would continue to support unbridled drains of resources while at the same time proposing

that the tax burden be increased on all other taxpayers. With declining revenues, every program from education to corrections to health services will be severely curtailed. If the state doesn't have the money to put textbooks in the schools why then do we need the highly touted, high-paying jobs the advocates for the industry promise? The next generation may not even know how to read given the cuts to the education budget.

Again, lawmakers must ask themselves whether or not this incentive is appropriate in these dire financial times. Given that there are many other proposals in the legislature to hike tax rates for either the general excise or net income taxes, taxpayers will find the continuance of these targeted business tax credits frightening. Frightening because these very lawmakers are supposed to represent the best interest of their constituents. Raising taxes on constituents while still handing out money to favored groups will engender the ire of constituents. The finger of blame for these potential increases in tax burden should not stop at lawmakers, but be placed squarely on those in the community who continue to push for these targeted tax credits. Perhaps those proponents should be asked to pick up the tab for this reckless expenditure of precious tax dollars.

While it is gratifying to know that lawmakers have finally realized that they need to evaluate the effectiveness of some of these tax incentives, it comes a tad late, but better later than never. What is appalling is that lawmakers wish to continue the credit for another five years before the evaluation is made. So no matter what the evaluation finds, the credits will go on without further review. Rather than extending it for an irrelevant period of time, the extension should be made co-terminus with the submission of the study so that policymakers can have the evaluation and recommendations before them before they decide the fate of the credit.

Finally, it should be noted that this state credit basically tracks the federal tax credit for research activities, including the disqualification for the credit should any part of the cost of the research be supported by federal grants. It would be interesting how many of the claims for this state research credit were disqualified because all or a part of the research activities were paid for with funds from federal grants.

Digested 3/29/11

**Comments to the Senate Committee on Ways and Means  
Wednesday, March 30, 2011 at 9:30 a.m.  
Conference Room 211, State Capitol**

**RE: HOUSE BILL NO. 1642 HD2 SD1 RELATING TO HIGH TECHNOLOGY**

Chair Ige, Vice Chair Kidani, and Members of the Committee:

The Chamber of Commerce of Hawaii ("The Chamber") supports HB 1642 HD2 SD1 relating to High Technology with amendments.

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 1642 HD2 extends the income tax credit for qualified research activities for five years and places an annual aggregate cap on the tax credit.

The Chamber supports this measure with the following amendments:

- Amend reporting requirements.
  - The Chamber supports the requirements as stated in SB 753 SD2 with the following clarifications:
    - *Remove* "invention disclosures" (lines 3-4)
      - Justification: This would be harder to track consistently when the industry as a whole does not follow this practice, only some companies claim to track this.
    - *Change* "Filed intellectual property..., provisional patents, and patents issued or granted" to read: **(5) Patents filed: (a) provisional, (b) full; and patents issued and granted.**
      - Justification: Patents issued/granted happens after the start of the filing process, so if we just track the filed IP metric, we may not be capturing all the near term activities and results.
    - *Add* a stricter reporting requirement: same deadline, same penalty and the survey must be filed to receive the tax credit.
- Require DOTAX reported data to go to DBEDT for economic analysis reports.

- This will take into account the income, payroll and other taxes these companies have paid in order to receive the credit. The tax credit can only be claimed for qualified research conducted in Hawaii and for 20% of the qualified expenditures. This refund occurs after the company files its tax return. So, R&D tax credits for 2011 would not be paid until 2012 and most of the payments will be in the latter half of the year. Therefore, the state receives the benefits of a business base now and doesn't pay for on average 18 months later.
- Also, DBEDT is probably the more appropriate agency to evaluate the economic impacts.

While technically referred to as a "tax credit", this credit could be viewed as a sound state "investment" that has the proven potential to diversify the economy exponentially and create meaningful careers in skilled, technical and manufacturing jobs.

This is a prime opportunity to promote the R&D sector in our state and support our small local companies in the R&D industry so that it can continue to flourish. This will allow them to provide jobs for our talented citizens and ensure that our keiki has 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 by spurring spin-off activities resulting from successful innovations. This would include production and manufacturing businesses that would further expand business activity and create skilled jobs outside the service and retail sectors.

Thank you for the opportunity to provide testimony. We respectfully ask that the committee pass this measure with the proposed amendments.

Written Statement of  
**YUKA NAGASHIMA**  
**Executive Director & CEO**  
High Technology Development Corporation  
before the  
**SENATE COMMITTEE ON WAYS AND MEANS**  
March 30, 2011  
9:30 AM  
State Capitol, Conference Room 211

In consideration of  
**HB 1642 HD2 SD1 RELATING TO HIGH TECHNOLOGY**

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

The High Technology Development Corporation (HTDC) respectfully submits comments in support of HB 1642 HD2 SD1. The state tax credit for research activities has 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 create high-wage job opportunities in our economy. Over the past nine years, the tax credit claims under this program averaged approximately \$11-\$12 million a year. As the credit can only be claimed for qualified research conducted in Hawaii and only for 20% of the qualified expenditures, the cost of the program is partially offset by taxes paid on expenditures and payroll. Such initiative is especially prudent now for Hawaii to hang onto the high-wage jobs we have already created, due to the suspension of earmarks as well as the sunset of Act 221. Just in properties managed by HTDC, the impact of our tenants with respect to the moratorium of earmark is estimated to be \$50M, already forcing those companies to lay off their workers.

HTDC's recommendations for further improvement of this bill, are as follows:

**1. Add stronger reporting requirements** that are in line with the R&D activities (vs. items optimized for the purpose of the investment tax credit portion of Act 221). HTDC suggests starting with the list the Senate version of this bill required, and add "patents filed" (in addition to patents granted), and remove "invention disclosures" (as it is an internal process to R&D companies not consistently practiced, and will not function well as a measure of economic activity). Further, add a stricter reporting requirement: same deadline, same penalty (\$1000/mo.) AND the survey MUST be filed to receive the tax credit.

**2. DoTAX reported data to go to DBEDT for economic impact reports.**

HTDC also recommends that after the sets of information are collected by DoTAX that DBEDT be given the aggregated, anonymized data for analysis so that DBEDT may

provide an appropriate economic impact report to the legislature. Because this is an economic stimulus measure, it is not sufficient for the legislature to know the immediate liabilities to the State. We must also take into account the income, payroll and other taxes these companies must have already paid in order to receive the R&D tax credits. The DBEDT staff is better suited to such analyses, given proper resources, to factor in the economic multipliers and produce impact reports. Doing so will bring further synergy to other reports that DBEDT is already mandated to provide (e.g., emerging industries report, etc.).

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



Written Statement of

**KARL FOOKS**

**President**

Hawaii Strategic Development Corporation

before the

**SENATE COMMITTEE ON WAYS AND MEANS**

March 30, 2011

9:30 AM

State Capitol, Conference Room 211

In consideration of

**HB 1642 HD2 SD1 RELATING TO HIGH TECHNOLOGY.**

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

The Hawaii Strategic Development Corporation (HSDC) strongly supports HB 1642 HD2 SD1. This bill reinstates the state tax credit for research activities that 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 create high-wage job opportunities in our economy.

Over the past nine years, the tax credit claims under this program averaged approximately \$11 million a year. As the credit can only be claimed for qualified research conducted in Hawaii and only for 20% of the qualified expenditures, the cost of the program is in large part offset by taxes paid on expenditures and payroll, not only on the qualified research activities, but also the broader scope of technology related economic activity supported by the research expenditures.

HSDC recommends the definitions of "Qualified high technology business" and "Qualified research" be amended to reflect current industry requirements.

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



**Written Testimony of**

**James P Karins,  
President, Pukoa Scientific**

**before the**

**Senate Committee on Ways and Means  
Wednesday March 30, 2011, 9:30 AM  
Conference Room 211**

**RE: HOUSE BILL NO. 1642 HD2 SD 1 RELATING TO HIGH TECHNOLOGY**

Chair Ige, Vice Chair Kidani, and Members of the Committee:

Pukoa Scientific strongly supports this bill with minor amendments described below. Pukoa Scientific is a small dual-use company located in the Manoa Innovation Center. It has 7 full-time employees working on image processing technologies. Since it was founded in 2004 Pukoa has utilized the R&D tax credit to pursue and win very competitive contracts that otherwise would have been nearly impossible to obtain, to write and file patents for its novel algorithms, and to fund part-time students.

Pukoa strongly supports this measure with the following amendments:

- Eliminate sections D and E of HRS 235-110.9. Industry and DoTAX agree that this section is redundant with the more meaningful reporting requirements of section I in this bill. Section D and E are administratively burdensome and add no value to the process.
  -
- Modify subsection J(5) with the following clarifications:
  - *Remove* “**invention disclosures**” (lines 3-4)
    - Justification: This would be harder to track consistently when the industry as a whole does not follow this practice, only some companies claim to track this.
  - *Change* “**Filed intellectual property..., provisional patents, and patents issued or granted**” to read: **(5) Patents filed: (a) provisional, (b) full; and patents issued and granted.**

- Justification: Patents issued/granted happens after the start of the filing process, so if we just track the filed IP metric, we may not be capturing all the near term activities and results.
- *Add* a stricter reporting requirement: same deadline, same penalty and the survey must be filed to receive the tax credit.
- Change the definition in subsection F for a “Qualified High Technology Business” to that defined in HRS 235-7.3

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 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.

### 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**. Thank you for the opportunity to express our views.



**COMMENTS TO THE SENATE WAYS AND MEANS**

MARCH 30, 2011

9:30 AM

ROOM 211

HAWAII STATE CAPITOL

**RE: HOUSE BILL NO. 1642 HD2 SD1 RELATING TO HIGH TECHNOLOGY**

Dear Chair Ige, Vice Chair Kidani and Members of the Committee:

Thank you for the opportunity to submit comments in support of **HB 1642 HD2 SD1** relating to high technology with amendments.

Referentia is a Hawaii-based software innovation company committed to building a sustainable high technology company in Hawaii and providing interesting science and technology jobs today and in the future. HB 1642 HD2 extends the income tax credit for qualified research activities for five years and places an annual aggregate cap on the tax credit. This bill supports companies like Referentia that bring outside capital to our State's economy and create innovative technologies here in Hawaii.

**Proposed amendments to HB 1642 HD 2 SD1**

In order to maximize and sustain the outcome of this credit to benefit Hawaii's economy, Referentia respectfully requests that the committee amends the bill to:

- Eliminate the annual aggregate cap on the tax credit.
  - Referentia agrees with the Department of Taxation (DOTax) that the cap is unnecessary given the relative stability of claims over the past nine years, which averaged about \$11-\$12 million a year.
  
- Add reporting requirements. Referentia supports the requirements as stated in SB 753 SD2 with the following clarifications:
  - *Remove* "invention disclosures" (lines 3-4)
    - Justification: This would be harder to track consistently when the industry as a whole does not follow this practice.
  - *Change* "Filed intellectual property..., provisional patents, and patents issued or granted" to read: **(5) Patents filed: (a) provisional, (b) full; and patents issued and granted.**
    - Justification: Patents issued/granted happens after the start of the filing process. So, if we track only the filed IP metric, we may not capture all the near-term activities and results.
  - *Add* a stricter reporting requirement: same deadline, same penalty and the survey must be filed to receive the tax credit.
  
- Require DOTax reported data go to DBEDT for economic analysis reports.
  - Justification: DBEDT is the more appropriate agency to evaluate the economic impacts.
  - This takes into account the income, payroll and other taxes that companies have paid in order to receive the credit. The tax credit can only be claimed for qualified research conducted in Hawaii and 20% of the qualified expenditures. This refund occurs after the

company files its tax return. So, R&D tax credits for 2011 would not be paid until 2012 and most payments will be made in the latter half of 2012, enabling the State to receive benefits of a business base in the current year, but not refund the tax credits until on average 18 months later.

### **Role of the Defense and Dual Use Technology Industry in Hawaii**

The large presence of the military in Hawaii has spurred the development of the dual use technology industry in Hawaii and has helped to establish the critical role Hawaii plays in national defense. The Defense industry is a key economic driver in the State's economy and has helped provide R&D funding for small local companies, like Referentia, to grow and develop technology solutions for critical and complex DoD needs. These solutions are readily transitionable to other key areas of national and international importance.

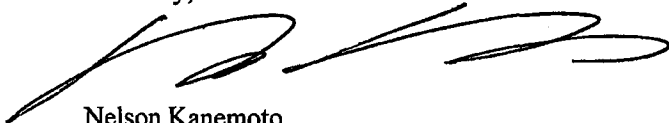
The R&D tax credit is an effective way to help drive innovation, boost the economic development of our industry and create high value STEM careers for the next generation.

Without the R&D credit, small businesses like Referentia may be forced to curtail our investment in R&D. Because of the forward-looking nature of research, few R&D investments have a payoff horizon shorter than one year. The R&D tax credit is critical to encourage R&D, foster high-wage job growth, and enable Hawaii to compete as an economic stronghold of innovation nationally and internationally.

By supporting the R&D tax credit, you will enable dual-use technology firms such as Referentia to keep investing in the future of our companies, our employees, and our State.

We urge you to support the R&D tax credit through HB 1642 HD 2 SD1 with the proposed amendments.

Sincerely,



Nelson Kanemoto  
President and CEO



**COMMENTS TO THE SENATE WAYS AND MEANS**

MARCH 30, 2011

9:30 AM

ROOM 211

HAWAII STATE CAPITOL

**RE: HOUSE BILL NO. 1642 HD2 SD1 RELATING TO HIGH TECHNOLOGY**

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**Proposed amendments to HB 1642 HD 2 SD1**

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- Add reporting requirements. Referentia supports the requirements as stated in SB 753 SD2 with the following clarifications:
  - Remove "invention disclosures" (lines 3-4)
    - Justification: This would be harder to track consistently when the industry as a whole does not follow this practice.
  - Change "Filed intellectual property..., provisional patents, and patents issued or granted" to read: **(5) Patents filed: (a) provisional, (b) full; and patents issued and granted.**
    - Justification: Patents issued/granted happens after the start of the filing process. So, if we track only the filed IP metric, we may not capture all the near-term activities and results.
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company files its tax return. So, R&D tax credits for 2011 would not be paid until 2012 and most payments will be made in the latter half of 2012, enabling the State to receive benefits of a business base in the current year, but not refund the tax credits until on average 18 months later.

### **Role of the Defense and Dual Use Technology Industry in Hawaii**

The large presence of the military in Hawaii has spurred the development of the dual use technology industry in Hawaii and has helped to establish the critical role Hawaii plays in national defense. The Defense industry is a key economic driver in the State's economy and has helped provide R&D funding for small local companies, like Referentia, to grow and develop technology solutions for critical and complex DoD needs. These solutions are readily transitionable to other key areas of national and international importance.

The R&D tax credit is an effective way to help drive innovation, boost the economic development of our industry and create high value STEM careers for the next generation.

Without the R&D credit, small businesses like Referentia may be forced to curtail our investment in R&D. Because of the forward-looking nature of research, few R&D investments have a payoff horizon shorter than one year. The R&D tax credit is critical to encourage R&D, foster high-wage job growth, and enable Hawaii to compete as an economic stronghold of innovation nationally and internationally.

By supporting the R&D tax credit, you will enable dual-use technology firms such as Referentia to keep investing in the future of our companies, our employees, and our State.

We urge you to support the R&D tax credit through HB 1642 HD 2 SD1 with the proposed amendments.

Sincerely,



Jill Takaazu Harper  
Vice President  
Business Operations



**COMMENTS TO THE SENATE WAYS AND MEANS**

MARCH 30, 2011

9:30 AM

ROOM 211

HAWAII STATE CAPITOL

**RE: HOUSE BILL NO. 1642 HD2 SD1 RELATING TO HIGH TECHNOLOGY**

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**Proposed amendments to HB 1642 HD 2 SD1**

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By supporting the R&D tax credit, you will enable dual-use technology firms such as Referentia to keep investing in the future of our companies, our employees, and our State.

We urge you to support the R&D tax credit through HB 1642 HD 2 SD1 with the proposed amendments.

Sincerely,



Nancy Downes  
Program Manager