

Written Statement of

KARL FOOKS
President

Hawaii Strategic Development Corporation
before the
HOUSE COMMITTEE ON FINANCE
MARCH 1, 2011
11:00 AM
State Capitol, Conference Room 308

In consideration of
HB 983 HD1 RELATING TO HAWAII STRATEGIC DEVELOPMENT CORPORATION

Chair Oshiro, Vice Chair Lee, and Members of the Committee on Finance:

Hawaii Strategic Development Corporation (HSDC) strongly supports HB 983 HD1, a bill that provides a financing mechanism that will support a multi-year investment program that can be implemented this year and support Hawaii's economic recovery and growth. This financing mechanism is structured to not have a budget impact during this biennium and to have a maximum budget impact of no more than \$20 million in any one fiscal year in future years. HSDC offers comments to HB 983 HD1 to enhance the effectiveness of the bill.

Capital Formation a Key Part of an Innovation Strategy

It took a conscious effort by government to establish tourism in Hawaii, and it will require that same discipline to establish digital media, information technology, nanotechnology, ocean sciences, biotechnology, aerospace, astronomy and other innovation fields. These industries bring dollars into Hawaii, with minimal impacts on our environment, enhance the quality of education, lead our drive toward self-sufficiency, and create high paying jobs for our local families.

However, for Hawaii to successfully foster innovation-led economic growth, an infrastructure and an ecosystem that supports entrepreneurialism, commercialization, and business formation must be established and maintained. Capital formation is a key ingredient of an innovation ecosystem and many states, including Hawaii, have used state sponsored investment programs to support capital formation in their regions. Hawaii Strategic Development Corporation (HSDC) was established in 1991 specifically for this purpose.

Technology Sector Economic Impact

The best metrics available to measure the economic impact of the technology sector in Hawaii is from DoTax's December 2010 report on Act 221. DoTax reported that, **excluding the performing arts sector**, 119 QHTB's reported 2009 Hawaii Revenues of \$145 million and

Hawaii Expenses of \$207 million. These companies employed 1,113 full time employees with an average wage of \$71,423 and 834 temporary or contract workers. It should be noted these metrics cover just a subset of the broader technology sector in Hawaii and that over the 2002-2009 time period, the broad technology sector in Hawaii, representing 25,412 jobs in 2009, experienced employment growth of 3.4% against total civilian employment growth of 1.6%. A significant portion of the job growth came from the QHTB companies.

A much harder metric, wealth and human capital creation are also important outcomes of a technology based economic development program. Investments in this sector are risky and it often takes many years before returns are realized on the small subset of successful investments. However, it is important to note that Hawaii has experienced significant re-investment in Hawaii's economy from successful entrepreneurs, investors, and companies in this sector. Successful entrepreneurs become angel investors and support the next generation of high growth companies. Successful entrepreneurs and investors invest in new funds and go on to found new businesses in the local economy. Failed start-ups also contribute by increasing the skills, experience, and networks of their founders. This increase in human capital makes them more employable and increases the probability of success in their next venture. In this way, over time, a critical mass of management talent, investment expertise, and capital is generated in the local economy that can sustain the further development of a high-tech, knowledge-based industry sector. HSDC's venture capital investment program will help support the development of an entrepreneurial ecosystem.

Consistent with Best Practices

Many states have adopted a fund of funds investment model to attract venture capital to their states. Due to fiscal constraints, states have looked at using tax credit backed financing mechanisms as a means to raise meaningful amounts of money, but to defer and spread the budget impact over many years. The Utah Fund of Funds was one such model that used the tax credits as collateral for bank financing. Since then, Tennessee pioneered the approach of selling tax credits to finance its investment program in order to bypass costly and restrictive bank financing. Tennessee recently completed raising approximately \$145 million from the sale of \$200 million in tax credits. These credits can only be claimed beginning in 2012 through 2019 and are subject to annual caps. By having a state agency, HSDC, directly sell the credits and capture the full monetization of the credits and the opportunity to capture the full upside of its investments to offset program costs, HB 983 HD1 is the next evolution in these financing mechanisms. Maryland, another state with innovative technology based economic development programs, is also pursuing legislation similar to HB 983 HD1.

HSDC's Investment Program

The financing mechanism provided by HB 983 HD1 will allow HSDC to implement a State capital formation program structured to mobilize and attract private capital to Hawaii's venture opportunities. To this end it will focus on perceived financing gaps and developing local fund management expertise. Two important objectives of the program are to

- 1) pool capital into professionally managed venture capital funds; and

- 2) network Hawaii's venture capital funds into the broader universe of mainland and international funds active in the sectors important to Hawaii.

In this way Hawaii companies will be able to leverage the domain expertise of experienced investors and gain access to follow-on capital for expansion.

HSDC investments in the earlier time periods helped to jump start the venture capital industry in Hawaii by providing capital to new, Hawaii-based funds. The investment activities of these pioneering funds helped to develop the investment, legal, accounting and management infrastructure necessary to support a venture capital industry. In later years, investment programs have been more targeted. For example, HSDC provided oversight to the Follow-on Funding Program, a \$5 million program to support commercialization of dual use technologies and the \$8.7 million Hydrogen Investment Capital Special Fund. HSDC's UPSIDE Fund supports commercialization of UH developed technologies. HSDC's limited partner investments have been leveraged over three times by private sector co-investments in the partnerships. In turn, these investments have been leveraged with company-level co-investments and follow-on investments by private sector investors.

Suggested Changes to HB 983 HD1

HSDC suggests that subsection (l) on line 20 of page 4 be deleted as it would provide the perverse incentive to HSDC to sell as many tax credits as cheaply as possible in a very short time frame or risk losing all the tax credits.

HSDC suggests that the following provisions be added to HB 983 HD1 to articulate parameters for an investment program:

The corporation shall comply with best practices standards and shall invest moneys raised or arranged by the corporation pursuant to this section subject to the following limitations:

- 1) The corporation shall invest principally in capital investment entities:
 - i) With managers or management teams with investing experience in start-up or early stage ventures; and
 - ii) With the ability to advise and mentor entrepreneurs and facilitate follow-on investments.
- 2) Not more than 15% of the aggregate moneys raised or arranged shall be invested in a single fund.
- 3) The corporation's capital commitment to a single fund shall not exceed 50% of the total capital committed to that fund, except in the case of proof-of-concept or pre-seed investment entities.
- 4) The corporation shall establish a target for investments in Hawaii-based businesses, businesses whose principal operations are located in Hawaii at the time of the initial investment, of 50% of the aggregate moneys raised or arranged pursuant to this section.

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

NEIL ABERCROMBIE
GOVERNOR

BRIAN SCHATZ
LT. GOVERNOR



FREDERICK D. PABLO
DIRECTOR OF TAXATION

RANDOLF L. M. BALDEMOR
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1530
FAX NO: (808) 587-1584

HOUSE COMMITTEE ON FINANCE

TESTIMONY OF THE DEPARTMENT OF TAXATION REGARDING HB 983 HD 1 RELATING TO THE HAWAII STRATEGIC DEVELOPMENT CORPORATION

TESTIFIER: FREDERICK D. PABLO, DIRECTOR OF TAXATION (OR
DESIGNEE)
COMMITTEE: FIN
DATE: MARCH 1, 2011
TIME: 11AM
POSITION: OPPOSED TO TRANSFERABLE CREDITS

This measure, among other things, funds the State private investment fund to allow transferability of tax credits.

The Department of Taxation ("Department") **opposes the subsequent credit transfer provisions** in this measure.

The Department is strongly opposed to any provision that allows Hawaii tax credits to be sold, assigned, or transferred from one taxpayer to another. Allowing taxpayers to market or sell their tax credits is fundamentally poor tax policy. Selling tax credits can be subject to abuse and suspect motivation by parties involved.

The Department's fundamental and primary concerns regarding credit transfers are the following:

- The transferability rewards a separate taxpayer unrelated to the taxpayer that generated the credit, which is fundamentally poor tax policy for encouraging behavior and directly rewarding that behavior;
- The Department is not setup to regulate credit transfers. Will the Department be required to establish a "Bureau of Credit Conveyances" in order to track transfers? If this is the case, resources will have to be dedicated to this;
- Abuse relating tax credit transfer prices will be problematic. The State will be out a \$1 when taxpayers will be transferring this \$1 for pennies;
- And, there will be problems on audit. The taxpayer being audited may have sold the

credit to another taxpayer.

The measure has the potential to reduce tax revenues by \$20 million per year.

Written Statement of
YUKA NAGASHIMA
Executive Director & CEO
High Technology Development Corporation
before the
HOUSE COMMITTEE ON FINANCE
March 1, 2011
11:00 AM
State Capitol, Conference Room 312

In consideration of
**HB 983 HD1 RELATING TO HAWAII STRATEGIC DEVELOPMENT
CORPORATION**

Chair Oshiro, Vice Chair Lee, and Members of the Committee on Finance.

High Technology Development Corporation (HTDC) is in support of HB983 HD1, which issues tax credits to the Hawaii Strategic Development Corporation (HSDC), and offers some suggestions to further improve the measure.

While capital is not the only ingredient needed for a healthy innovation pipeline and the ecosystem we need to establish and nurture, there is currently no capital formation strategy or tool for the State of Hawaii with the sun setting of Act 221/215. Further, HSDC has not received any infusion to invest for almost 10 years.

There have been many discussions and concerns about the effectiveness of Act 221/215, and alleged abuse. This method of capital formation via providing funds to HSDC to invest per their statute, minimizes these concerns. Further, beyond having funds to invest in support of local companies, the funds will also command smart money, that is, expertise, mentorship, and networks our companies require to attract future follow-on funding from the mainland.

SUGGESTIONS:

HTDC suggests that the **1 year expiration clause be either removed** or extended to a longer period, such as 5 years, in order for the program to effectively function. Having a 1 year expiration may not be in the best interest of the State to command the best rate possible for the tax credits and for the program to function as initially designed. Such a short time period would only incentivize HSDC to sell the tax credits as quickly as possible rather than for the highest price possible. There already exists an annual cap for the industry to claim the purchased tax credits within this measure. That clause alone is sufficient to limit the State's exposure for any given year.

Further, to address the Legislature's concerns regarding the fiscal environment, HTDC suggests that rather than putting a 1 year expiration clause or to defer this measure, **structure**

this initiative as a pilot program, limiting the 100 million dollar figure over 10 years to a smaller amount in the initial years (e.g., **\$4 million annually, making it a \$20 million investment**), to gain a level of comfort among all the stakeholders during these initial years. The proposed program is already fiscally conservative, pushing out the budgetary impact to the State beyond this biennium.

The State's investment to the innovation-based economy development will not require as nearly as much funds the State had to put on the books for Act 221/215. Further, by investing these monies via HSDC, the State is assured board oversight, the benefits of investing in fund-to-funds (where the winners are picked by experienced managers whose financial incentives are aligned with the State), and gain the attention of these fund managers who will be required to keep visiting Hawaii in search of new companies to invest in and providing valuable mentorship to them along the way.

Thank you for this opportunity to testify in support of this measure.

TAXBILLSERVICE

126 Queen Street, Suite 304

TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: MISCELLANEOUS, Hawaii strategic development corporation tax credits

BILL NUMBER: HB 983, HD-1

INTRODUCED BY: House Committee on Economic Revitalization and Business

BRIEF SUMMARY: Adds a new section to HRS chapter 211F to allow the state to issue \$100 million in tax credits to the Hawaii strategic development corporation (HSDC) that may be transferred or used to reduce the tax liability of any taxpayer subject to HRS chapters 235, 241, or 431:7-202; provided that the tax credits transferred by the corporation shall not be exercisable in a taxable year beginning before January 1, 2013 or ending after December 31, 2025.

The amount of tax credits transferred by the HSDC shall not exceed an aggregate total of \$20 million per fiscal year. Tax credits which exceed a taxpayer's income tax liability under HRS chapters 235 or 241 or section 431:7-202 shall be used in subsequent taxable years until exhausted. The HSDC shall not transfer or sell any tax credit at more than a thirty percent discount. Any unsold tax credits shall expire at the end of the calendar year in which they are issued.

Amends HRS section 211F-1 to add the definition of "tax credits" and "taxpayer."

EFFECTIVE DATE: July 1, 2112

STAFF COMMENTS: This measure proposes to authorize the transfer of \$100 million in tax credits to the HSDC that may be transferred or used to reduce the tax liabilities of any taxpayer subject to HRS chapter 235 (income), chapter 241 (banks and financial institutions) and section 431:7-202 (insurers other than insurers of life insurance contracts, ocean marine insurance contracts, and real property title insurance contracts).

It should be noted that the state has not tracked the cost-benefit of any of the tax credit programs as recommended by the most recent Tax Review Commission. The state has not ascertained if taxpayer dollars that have been spent have gotten any economic returns that these investments may have had. There is sparse data on how these credits affect the equity of the overall tax system. At best, the portion of the technology business that this measure impacts remains a small part of the employment pie while commanding a comparatively large share of state resources. The bottom line is that this measure represents an outflow of real dollars from the state treasury. At the very least, one of the conditions of the credit should be a filing by companies wanting to claim the credit to insure that they produce expected outcomes and the amount that was invested in Hawaii.

Finally, one has to ask what is the rationale behind handing over \$100 million of tax credits to the HSDC? Will taxpayers and lawmakers be abdicating their oversight as to how these credits will benefit the state, the community and the economy? Where is the accountability and transparency in handing out these credits? This measure contains some serious flaws of fiduciary responsibility.

Digested 2/28/11



**Testimony in Support of HB 983
Chenoa Farnsworth
Managing Director
Hawaii Angels**

**HOUSE COMMITTEE ON FINANCE
MARCH 1, 2011
11:00 AM
State Capitol, Conference Room 308**

In consideration of
HB 983 HD1 RELATING TO HAWAII STRATEGIC DEVELOPMENT CORPORATION

Chair Oshiro, Vice Chair Lee, and Members of the Committee on Finance:

Hawaii Angels strongly supports HB 983 HD1, a bill that provides a financing mechanism that will support a multi-year investment program to be managed by the Hawaii Strategic Development Corporation (HSDC) that can be implemented this year and support Hawaii's economic recovery and growth. This financing mechanism is structured to not have a budget impact during this biennium and to have a maximum budget impact of no more than \$20 million in any one fiscal year in future years.

Capital Formation a Key Part of an Innovation Strategy

Capital formation is a key ingredient of an innovation ecosystem and many states, including Hawaii, have used state sponsored investment programs to support capital formation in their regions. Hawaii Strategic Development Corporation (HSDC) was established in 1991 specifically for this purpose.

Technology Sector Economic Impact

Driven primarily by incentive programs such as Act 221, technology sector company formation and job creation in the sector skyrocketed from the 2000-2010 timeframe. In total since 2002 Hawaii Angels was instrumental in the launch and funding of 40 new companies in the sector. Most of these companies are still in business but without follow on funding they may not continue to grow and create more jobs and activity for the Hawaii economy. HSDC's venture capital investment program will help support these existing activity in the sector and the development of a more robust entrepreneurial ecosystem. Without additional programs at this time we will slide backwards as far as sector growth and capital formation are concerned.

Consistent with Best Practices

Many states have adopted a fund of funds investment model to attract venture capital to their states. Due to fiscal constraints, states have looked at using tax credit backed financing mechanisms as a means to raise meaningful amounts of money, but to defer and spread the budget impact over many years. By having a state agency, HSDC, directly sell the credits and capture the full monetization of the credits and the opportunity to capture the full upside of its investments to offset program costs, HB 983 HD1 is the next evolution in these financing mechanisms.

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In this way Hawaii companies will be able to leverage the domain expertise of experienced investors and gain access to follow-on capital for expansion.

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

FINTestimony

From: mailinglist@capitol.hawaii.gov
ent: Saturday, February 26, 2011 6:58 AM
To: FINTestimony
Cc: swartzg001@hawaii.rr.com
Subject: Testimony for HB983 on 3/1/2011 11:00:00 AM

Testimony for FIN 3/1/2011 11:00:00 AM HB983

Conference room: 308
Testifier position: oppose
Testifier will be present: No
Submitted by: gregory swartz
Organization: Individual
Address:
Phone:
E-mail: swartzg001@hawaii.rr.com
Submitted on: 2/26/2011

Comments:

This is total fraud and the knowing rape of Hawaii taxpayers. Who the heck gets these freely transferable tax credits which are available for no legitimate public purpose?