

NEIL ABERCROMBIE
GOVERNOR

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JOSHUA WISCH
DEPUTY DIRECTOR

To: The Honorable Clift Tsuji, Chair
and Members of the House Committee on Economic Development and Business

Date: Tuesday, February 5, 2013
Time: 9:00 a.m.
Place: Conference Room 312, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. No. 1401 Relating to Taxation

The Department of Taxation (Department) recognizes the importance of encouraging research and development, which in turn creates new jobs and greater prosperity for the State. However, the Department opposes this measure because the tax credit for qualified research activities has been the subject of great abuse and expensive and protracted litigation.

This measure reinstates the tax credit for qualified research activities for tax years 2013, 2014 and 2015, changes the definition of qualified high technology business to mean a business that conducts more than an unspecified percentage of its activities in qualified research, and requires that taxpayers claiming the credit file an annual survey with the Department.

Although this measure would adopt the federal requirements set forth under Internal Revenue Code (IRC) section 41, there is no requirement that the taxpayer actually claim the federal tax credit in order to qualify for the State tax credit for research activities. The Department believes that a taxpayer should be required to claim the federal credit under IRC section 41 in order to claim the State credit. Because the Internal Revenue Service (IRS) has far greater expertise in the matter and the resources to litigate it, this will help prevent taxpayers from making spurious claims of the credit, especially since this is an extremely generous refundable tax credit.

The Department also notes that this measure makes non-operative for purposes of the credit various IRC sections which are cited within IRC sections 41 and 280(c) but which are normally not operative for the State. These cited sections, however, are very important in proper application of the credit and to help prevent abuse of the credit and to prevent "double-dipping" of the credit by two or more qualified high technology businesses.

The research credit is also prone to abuse and very intensive litigation over the qualifications of the credit. For example, although the federal research credit was first allowed for internal use software in 1986, and despite numerous attempts by the Internal Revenue Service

to define what internal use software is, it has yet to issue final regulations on the issue. The result is extremely protracted litigation as to whether software is internal use or not. It is not uncommon for IRS litigation to exceed ten years before a final court decision on the matter can be had.

In addition, the issue of what is a supply has been very contentious, with companies claiming that an item built to their specifications outside the State is a “supply”, which is an allowable expense for credit purposes, rather than research conducted outside the State, which is not allowable for the Hawaii credit. This has led to costly and protracted litigation over what expenses are eligible for the credit. Because the resolution of this matter turns on very fact specific circumstances, it often entails the necessity to employ expert witnesses at great cost to the State.

Lastly, the measure requires that a business claiming the credit is required to submit a report to the Department, and based upon those reports, the Department must report to the legislature on the effectiveness of the tax credit under this section. The Department would note that it does not have the high technology expertise to evaluate the effectiveness of the tax credit.

Thank you for the opportunity to provide comments.



Written Statement of

Karl Fooks
President

Hawaii Strategic Development Corporation
and

Yuka Nagashima
Executive Director and CEO

High Technology Development Corporation

before the

HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS

February 5, 2013

9:00 AM

State Capitol, Conference Room 312

In consideration of

HB 1401 RELATING TO TAXATION.

Chair Tsuji, Vice Chair Ward, and Members of the Committee on Economic Development & Business:

The Hawaii Strategic Development Corporation (HSDC) and the High Technology Development Corporation (HTDC) respectfully **submit comments on HB 1401**. 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 create high-wage job opportunities in our economy.

HB 1401 proposes to amend the definition of a Qualified High Technology Business (QHTB) for the purposes of this credit. We recommend using the definition of a QHTB contained in Section 235-7.3(c), HRS. This will maintain consistency with Section (j)(1) of HB 1401 (page 8, line1) and with previous data collected under past tax credit programs.

HB 1401 includes important requirements to collect data and provide metrics on the effectiveness of the proposed research tax credit. We recommend that resources be appropriated to the Department of Taxation order that they are able to collect the data, analyze the impacts and report their findings.

Finally, the objective of HB 1401 is to promote economic development in the State. Supporting research activities alone will not accomplish this objective. We recommend the Committee also consider a comprehensive policy that supports the continuum of entrepreneurialism, commercialization and business formation capabilities needed to foster high



growth businesses. As part of an entrepreneurial ecosystem, a research tax credit program can be effective in creating sustainable high wage jobs.

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



Written Statement of
Dr. Patrick K. Sullivan
Founder & Chairman
Oceanit
before the
HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS
February 5, 2013, 09:00 AM
State Capitol, Conference Room 312
In Support of
HB1401 Relating to Taxation & HB559 Relating to Economic Development

To: Chair Tsuji, Vice Chair Ward, and Members of the Committee
From: Dr. Patrick K. Sullivan, Founder & Chairman, Oceanit
Re: **Testimony in Support of HB1401 Relating to Taxation & HB559 Relating to Economic Development**

Honorable Chair, Vice-Chair and Committee Members:

Thank you for the opportunity to submit testimony in **support of HB1401 and HB599.**

Oceanit currently employs about 160 scientists, engineers and support staff. We regularly host interns, school classes, and conduct numerous outreach activities for elementary thru college level keiki to introduce them to science and engineering careers. We let keiki know that there are exciting, decent paying jobs for them in Hawai'i if they pursue these careers. Many of them have returned to us, equipped with college degrees, wanting to work in science and engineering. It is our hope that we can continue to offer an alternative to keiki who want to work in an industry that is growing nationally as well as internationally, and to show them that world class technical work can thrive in Hawai'i.

The R&D credit has helped to jump start an industry that is in its infancy in Hawai'i. It has been responsible for job creation, as well as many long-term investments Oceanit has made that will set the stage for growth into the future. The reality is that without Hawai'i's R&D tax credit, Oceanit would not have been able to make these investments.

Because of the forward-looking nature of research, few R&D investments have short-term rewards. These bills would re-establish a temporary R&D income tax credit for qualified research activities in the State of Hawai'i, to help provide longer-term continuity for an industry that is struggling to grow. We urge you to maintain the momentum that you started.

Thank you for your continued support of R&D as the stimulant to an innovative Hawai'i STEM economy that our keiki can be a part of.

Sincerely,

Dr. Patrick K. Sullivan
Founder & Chairman



Written Recommendation for Amendment

James P Karins, PhD
President, Pukoa Scientific
before the

HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS

February 5, 2013

9:00 AM

State Capitol, Conference Room 312

In consideration of
HB 1401 RELATING TO TAXATION

Chair Tsuji, Vice Chair Ward, and Members of the Committee on Economic Development & Business:

Pukoa Scientific supports HB 1401.

Pukoa like most of the other DoD research and development contractors, has suffered over the past couple of years through significant reductions in available funding while withstanding increased costs due to lost R&D tax credits, increased unemployment insurance and other taxes. The proposed extension of the R&D tax credit helps put Hawaii based companies on a level playing field to mainland companies that have lower costs of business and their own R&D tax credits.

Pukoa requests that the committee consider extending the end date so that the small businesses can plan better. Pukoa would also request that the committee remove Section 2.d as it is a duplicative reporting requirement to the new Section 2.i

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

James P. Karins, PhD
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