

NEIL ABERCROMBIE  
GOVERNOR

SHAN TSUTSUI  
LT. GOVERNOR



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

FREDERICK D. PABLO  
DIRECTOR OF TAXATION

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. 0559 Relating to Economic Development

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 implements the tax credit for qualified research activities for an additional five years, clarifies the method of calculating the tax credit, and amends the definition of "qualified high technology business". It repeals existing certification requirements, but establishes new reporting requirements and requires the Department of Business, Economic Development, and Tourism to conduct studies to measure the effectiveness of the tax credit and to submit reports to the legislature. The measure is effective upon its approval and applicable to tax years beginning after December 31, 2012.

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 also 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.

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 559 RELATING TO ECONOMIC DEVELOPMENT.**

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 559**. 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 559 would align the calculation of the State research tax credit with the approach used by the Federal research tax credit provisions by allowing a tax credit only for qualified research above an annual base amount. This will reduce the dollar amount of credits claimed, but also reduce the effectiveness of the credit as a tool for promoting economic development.

HB 559 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 and Department of Business, Economic Development and Tourism in order that they are able to collect the data, analyze the impacts and report their findings.

Finally, the objective of HB 559 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 559 RELATING TO ECONOMIC DEVELOPMENT**

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

Pukoa Scientific supports HB 559.

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 removing the reference to the base. This aspect of the federal R&D tax credit incentivizes but also benefits large corporations. The smaller entities in Hawaii do not have the internal funding to always increase R&D expenditures.

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

James P. Karins, PhD  
[Karins@pukoa.com](mailto:Karins@pukoa.com)  
(407)694-4485