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SUBJECT: INCOME, Tax credit for research activities

BILL NUMBER: SB 736; HB 559 (Identical)

INTRODUCED BY: SB by Dela Cruz, Chun Oakland and 5 Democrats; HB by Har, Cullen, Fale, Oshiro, Say, Tsuji, Yamashita

BRIEF SUMMARY: Amends HRS section 235-110.91 to provide that the federal tax provisions in section 41 as that section was enacted on December 31, 2011, shall remain in effect for purposes of determining the state income tax credit under this section. Provided further that the federal tax provisions in section 41, as enacted on December 31, 2011, shall apply only to expenses incurred for qualified research activities after December 31, 2012.

Also requires 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 is claimed under this section. Permits the department to adjust the due date of the annual survey by rule. Companies that fail to file the survey shall be subject to a fine of up to \$2,000 for each month of a delay to file. Requires a qualified high tech business to file an annual survey before claiming the tax credit for qualified research.

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; (5) filed intellectual property, including invention disclosures, provisional patents, and patents issued or granted; and (6) federal and state income tax returns and documents related to deductions for tax credits for research activities.

The department of taxation may request any additional information necessary to measure the effectiveness of the tax credit, such as information related to patents. Also directs the department of taxation to allow the department of business, economic development, and tourism (DBEDT) to access data collected under this section to conduct economic impact analyses and produce legislative reports.

Requires DBEDT to prepare summary descriptive statistics by category and ensure that the information be reported at the aggregate level to prevent compromising identities of qualified high technology business investors or other confidential information. DBEDT shall also identify each qualified high technology business that is the beneficiary of tax credits claimed under this section. Requires DBEDT to report the information to the legislature by December 21 of each year.

Further requires DBEDT to use the information collected to study the effectiveness of the tax credit and 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 21 of each year.

Changes the expiration of the tax credit for research activities from 12/31/10 to 12/31/17.

EFFECTIVE DATE: Upon approval; applicable to tax years beginning after December 31, 2012

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 and tax incentives, to encourage high tech businesses and individuals associated with high tech businesses to locate in the state. It should be noted that while the credit for research activities enacted by Act 178, SLH 1999, expired on 12/31/10 and this measure would reenact the credit, it is questionable whether the methodology proposed by this measure is appropriate. Since the credit expired on 12/31/10, the method proposed by this measure merely changes the expiration date of the existing statutory language, and it would appear to be more appropriate to restate the provisions as language in a new section under the income tax law.

While the re-adoption of the credit for research activities would require 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 re-enact the credit for research activities for a five-year period, it would add another 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) despite the drive by the current administration to enhance broadband communications in Hawaii, broadband passing through Hawaii is already everywhere and is not a selling point; (7) that people can fly direct and therefore Hawaii's mid-Pacific location is not 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 given an economy that is still trying to recover from the recent economic downturn. Given that there are many other proposals in the legislature to hike tax rates, taxpayers will find the continuance of these targeted business tax credits distasteful. Reprehensible probably is more appropriate given that these are the lawmakers who 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.

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edbtestimony

From: mailinglist@capitol.hawaii.gov
Sent: Monday, February 04, 2013 5:08 PM
To: edbtestimony
Cc: alan.hayashi@baesystems.com
Subject: Submitted testimony for HB559 on Feb 5, 2013 09:00AM

Categories: LATE TESTIMONY

HB559

Submitted on: 2/4/2013

Testimony for EDB on Feb 5, 2013 09:00AM in Conference Room 312

Submitted By	Organization	Testifier Position	Present at Hearing
Alan Hayashi	Individual	Support	Yes

Comments: ALAN S. HAYASHI 207-4 Kawaihae Street Honolulu, Hawaii 96825 TESTIMONY TO THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT AND BUSINESS Tuesday, February 5, 2013 @ 9:00 am Conference Room #312 RE: HB 559 "RELATING TO ECONOMIC DEVELOPMENT" Chair Tsuji, Vice Chair Ward, and members of the House EDB Committee: My name is Alan Hayashi and I am testifying as an individual employed by a large defense contractor involved in research and development, and as the representative of the ED&I Committee of the Chamber of Commerce. My testimony is in support of the intent of HB 559. The High Technology industry's research and development (R&D) function is one that could employ Hawaii's brightest and best STEM graduates and could grow to be a substantial contributor to the kind of green "clean" economy we are striving to develop in Hawaii. Unfortunately, the 2008 economic downturn and corresponding lack of funding for research and development dealt a severe blow to the High Technology industry and the local technology community. The suspension in 2011 of the R&D Tax credit was crippling to many small R&D firms. Some were sold to "off island" interests, and some severely cut back on employees, or closed. Because the industry is based on invention and innovation of intellectual property (IP), firms are transportable beyond geographic boundaries....large factories are not necessary. Many sections of the country offer incentives to attract high technology industry to their cities. As such the competition for high technology companies is always present. Many stay in Hawaii, because they grew up here and enjoy the life style and closeness of family. However, in these competitive times, that is not enough. Senator Inouye provided some much need R&D funding, but that is no longer available. Unless Hawaii offers a competitive economic environment many will leave and the dream of a society of smart young folks solving problems and innovating will forever disappear from Hawaii. The window of opportunity is closing for a viable technology community to survive. The brightest and best of our technology folks will leave Hawaii for opportunities elsewhere. If the Legislature values the High Technology capability, I urge you to support the industry with re-instatement of a tax credit, or some incentive. I also suggest the credit be integrated with a manufacturing / production function as proof that the "good idea" (IP) can be converted to a product (software, or hardware). The industry always struggles to convert the IP to a product which ensures a cash flow until the next "good idea" can be developed and produced as product. Unfortunately, the good ideas do not always result in viable products. It always does take time to develop good ideas into a product, and R&D companies need assistance in this period. Venture capital companies can help, if they invest in Hawaii companies, and the "Accelerator" funding to HSDC will be helpful to grant funding for the ideas (IP). However, you are not addressing the

production / manufacturing phase which sometime require expensive specialized equipment. A credit (retroactive) based on equipment costs and installation labor could be a way to incorporate the production / manufacturing function in the credit. Thank you for consideration of my position on the issue and for the opportunity to present testimony. I will be glad to answer any questions you might have.

Please note that testimony submitted less than 24 hours prior to the hearing, improperly identified, or directed to the incorrect office, may not be posted online or distributed to the committee prior to the convening of the public hearing.

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