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To: The Honorable David Y. Ige, Chair
and Members of the Senate Committee on Ways and Means

Date: Friday, March 28, 2014
Time: 9:15 a.m.
Place: Conference Room 211, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. No. 2338, S.D. 1, Relating to Tax Credit for Research Activities

The Department of Taxation ("Department") strongly **supports** H.B. 2338, S.D. 1, an Administration measure, to clarify the intent of Act 270, Session Laws of Hawaii 2013. This measure will ensure conformance of the State Tax Credit for Research Activities ("TCRA") to the federal TCRA provisions, which will enable the Department to efficiently administer and enforce the provisions of this tax credit.

This measure is proposed by the Department to clarify that the State TCRA is not available for research conducted outside of the State, eliminate the requirement that the Department certify all research credit claims, and clarify that if a taxpayer fails to submit to Department of Business, Economic Development, and Tourism ("DBEDT") the required economic survey required under the State credit provisions, such failure is a waiver of the right to claim the credit. The measure applies to taxable years beginning after December 31, 2013, and S.D. 1 has a defective effective date of July 1, 2050.

The federal TCRA is an incremental credit based on increases in research activities under Internal Revenue Code ("IRC") § 41(a). Taxpayers may choose to claim the credit under the Regular Research Credit ("RRC") method or the Alternative Simplified Credit ("ASC") method under IRC § 41(c)(5). The TCRA is a highly technical and extremely complex, such that the Department must rely on the expertise of the Internal Revenue Service ("IRS") in determining whether a TCRA claim is justified.

For example, when the State TCRA did not include the base period calculations for purposes of the credit as it did under Act 221, Session Laws of Hawaii 2001, the Department expended considerable audit resources to determine whether or not taxpayer claims for the TCRA were justified. Because the Hawaii TCRA is a refundable credit, the tendency is for taxpayers to be more aggressive in their approach so that its activities and expenditures fall within the parameters of the credit.

Validation of tax credit claims requires review of extremely detailed and technical information, and disputes concerning the credit are not easily resolved. It is not uncommon, for example, that audits and the related appeals regarding the federal TCRA involves extensive and costly litigation that often take more than ten years for complete resolution. Given that the Department does not have the personnel, resources and expertise to insure that claims for the credit are valid, the administration and enforcement of this credit is very difficult for the Department.

The TCRA is intended to encourage taxpayers to design, develop, and/or improve products, processes, techniques, formulas or software and intended to reward programs that pursue innovation. The Department strongly believes that taken together, the federal and the State TCRAs provide substantial incentives for such innovation, even for new start-up companies. For example, the ASC method allows taxpayers to claim research credits even if research costs remain the same or when costs may decline as compared to prior years. As such, it is not necessary to eliminate the reference to the base periods. Taxpayers are still eligible for the TCRA even when the amounts spent on qualified research have declined from the previous year.

The RRC equals 20% of a taxpayer's current-year qualified research expenses ("QREs") that exceed a base amount, which is determined by applying the taxpayer's historical percentage of gross receipts spent on QREs (the fixed-base percentage) to the four most recent years' average gross receipts. The fixed-base percentage may not exceed 16%, and the base amount may not be less than half of the current-year QREs. The ASC equals 14% of the QREs for the taxable year that exceed 50% of the average QREs for the three taxable years preceding the taxable year for which the credit is being calculated. If the taxpayer has no QREs in any one of the three preceding tax years, the ASC rate equals 6% of the QREs for the taxable year.

This measure first makes it clear that qualifying research activities must be done in Hawaii in order for the costs to qualify for the TCRA. Currently, the law requires that a cost be "incurred" in Hawaii in order for the cost to be qualifying research cost. However, where a cost is incurred is not readily determinable and does not necessarily mean that the research expense was performed in Hawaii. For example, a contract that is negotiated and signed in Hawaii can be classified as incurred in Hawaii, even though under the terms of the contract such research will be performed completely outside of Hawaii. This measure clarifies that any qualifying research cost must be performed in Hawaii in order to qualify for the TCRA.

Second, this measure eliminates the requirement that the taxpayer obtain certification from the Department concerning its claim for the credit. This certification requirement does not assist the Department and it creates a false impression in the taxpayer that by certifying the credit, the Department has audited and accepted the same. Given the complexity of the credit and the very short timeframe in which the certification must be obtained, it is only possible for the Department to give a cursory overview at the time of certification. Since the information

sought by the certification will be provided to DBEDT by means of the survey required by statute to be submitted, certification by the Department is duplicative, unnecessary and provides no meaningful benefits.

Finally, this measure also makes clear that submission of the survey is a requirement to making a valid claim for the credit. Currently, the statute requires submission of the required survey but imposes no penalty for failure to provide it. In the past, where no substantive penalty was imposed for failure to provide the information, taxpayers were recalcitrant in so providing it.

For example, a survey was required by virtue of Act 206, Session Laws of Hawaii 2007 for businesses obtaining funds pursuant to the former High Technology Business Investment Tax Credit under HRS § 235-110.9. While Act 206 allowed the imposition of a nominal fine in relation to the substantial amounts raised, it was difficult for the Department to obtain compliance from the businesses required to submit the information. Collection of the fine proved to be problematic, as because it is not considered a tax, collection must be made by the Attorney General's office through normal debt collection procedures. This measure will insure that such information is provided by denying the credit to a business who fails to comply with the requirement.

Thank you for the opportunity to provide comments.

Written Statement of
ROBBIE MELTON
Executive Director & CEO
High Technology Development Corporation
before the
SENATE COMMITTEE ON WAYS AND MEANS

Friday, March 28, 2014
9:15 a.m.
State Capitol, Conference Room 211
In consideration of

HB 2338 SD1 RELATING TO TAX CREDIT FOR RESEARCH ACTIVITIES.

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

The High Technology Development Corporation (HTDC) **supports** HB 2338 SD1 relating to Tax Credit for Research Activities. HTDC agrees that tax incentives are an important piece of the comprehensive strategy for the economic development of our technology industry and should follow the Department of Taxation draft with respect to section 41 of the Internal Revenue Code. HTDC comments that these efforts should be coordinated with HB1704 HD1 to build a cohesive strategy.

Thank you for the opportunity to offer these comments.

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SUBJECT: INCOME, Credit for research activities

BILL NUMBER: HB 2338, SD-1

INTRODUCED BY: Senate Committee on Economic Development, Government Operations and Housing

BRIEF SUMMARY: Amends HRS section 235-110.91 to clarify that the tax credit for research activities shall only be applicable to qualified research activities incurred after December 31, 2012 and shall not include research conducted outside the state.

Also eliminates the requirement that the taxpayer obtain certification for the research credit from the department of taxation. Provides that the failure of a qualified high technology business to submit the annual survey shall be considered a waiver to claim the credit.

EFFECTIVE DATE: July 1, 2050; applicable to tax years beginning after December 31, 2013

STAFF COMMENTS: This is an administration measure submitted by the department of taxation TAX-03 (14). The legislature by Act 270, SLH 2013, reenacted the tax credit for research activities for taxable years from 2013 to 2019. The proposed measure clarifies that the credit is applicable only to qualifying research activities performed in the state.

The proposed measure also eliminates the requirement that the taxpayer obtain certification by the department of taxation to claim the credit. It appears that due to the complexity of the credit and the very short time frame in which the certification must be obtained, the department is unable to provide more than a cursory overview of the information at the time of certification. Since such information is also provided to the department of business, economic development and tourism, the department of taxation has determined that the certification by the department of taxation is duplicative and unnecessary.

Digested 3/25/14