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To: The Honorable Derek S.K. Kawakami, Chair
and Members of the House Committee on Economic Development & Business

Date: Tuesday, February 3, 2015
Time: 9:00 A.M.
Place: Conference Room 312, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.B. 1068, Relating to High Technology

The Department of Taxation (Department) opposes this measure. Due to the complexity of this tax credit, the Department's ability to administer and enforce the provisions of the tax credit is severely hampered if the tax credit does not track the federal tax credit.

H.B. 1068 provides that sections 41 and 280C(c) of the Internal Revenue Code (IRC) shall be relied upon for calculating the State Tax Credit for Research Activities (TCRA), except that references to the base amount shall not apply and tax credit for all qualified research expenses may be taken without regard to the amount of expenses incurred for previous years. The measure is effective upon approval.

The federal TCRA is an incremental credit based on increases in research activities under IRC section 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 section 41(c)(5). The TCRA is a highly technical and extremely complex tax credit, 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 federal TCRA and the State TCRA were not in sync under Act 221, Session Laws of Hawaii 2000, the Department expended considerable audit resources to determine whether 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 as to what activities and expenditures fall within the parameters of the tax credit.

Validation of tax credit claims requires review of extremely detailed and technical

information, and disputes concerning the credit are not easily resolved. 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 tax 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 ASC method allows taxpayers to claim research credits, even if research costs remain the same or when costs 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 decline 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.

Currently, under IRC sections 41(f)(1)(A)(ii) and 41(f)(1)(B)(ii), a taxpayer is required to allocate research credits to each controlled group member "on a proportionate basis to its share of the aggregate of the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums, taken into account by such controlled group for purposes of this section." Thus, the group credit is allocated to group members based on a member's share of qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums, without regard to whether the member would have a stand-alone entity credit or what the amount of any such credit would be.

This measure would require substantial deviations in making this calculation for State tax purposes, as opposed to using the federal allocation, due to the deletion of the base periods that may be applicable to each taxpayer of the group. As a result, administration and enforcement of this tax credit will divert the Department's limited resources to administer and enforce a tax credit, rather than for revenue collection. The Department opposes this attempt to deviate from the federal TCRA.

Thank you for the opportunity to provide comments.



Chamber of Commerce HAWAII
The Voice of Business

**Testimony to the House Committee on Economic Development & Business
Tuesday, February 3, 2015 at 9:00 A.M.
Conference Room 312, State Capitol**

RE: HOUSE BILL 1068 RELATING TO HIGH TECHNOLOGY

Chair Kawakami, Vice Chair Kong, and Members of the Committee:

The Chamber of Commerce of Hawaii ("The Chamber") **supports** HB 1068, which allows for a credit for all qualified research expenses without regard to the amount of expenses for previous years.

The Chamber is the largest business organization in Hawaii, representing over 1,000 businesses. Approximately 80% of our members are small businesses with less than 20 employees. As the "Voice of Business" in Hawaii, the organization works on behalf of members and the entire business community to improve the state's economic climate and to foster positive action on issues of common concern.

The Chamber supports continuing efforts to develop the innovation sector of our economy. A diversified economy is important to Hawaii's economic long term viability. This bill will help provide much needed funding to a wider spectrum of small businesses as well as create opportunities for investments in a booming and diverse economy.

Thank you for the opportunity to testify.

Written Statement of
ROBBIE MELTON
Executive Director & CEO
High Technology Development Corporation
before the
HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS
Tuesday, February 3, 2015
9:00 a.m.
State Capitol, Conference Room 312
In consideration of

HB1068 RELATING TO HIGH TECHNOLOGY.

Chair Kawakami, Vice Chair Kong, and Members of the Committee on Economic Development & Business.

The High Technology Development Corporation (HTDC) **supports the intent** of HB 1068 which allows for a credit for all qualified research expenses without regard to the amount of expenses for previous years.

HB1068 proposes to expand the R&D tax credit to include all of a company's R&D expenditure in the State. In 2013, ten companies claimed the current credit and completed the required survey. They reported an aggregated expenditure of \$25.7 million in research activities in Hawaii. Among those, \$17.3 million (67.2%) were eligible for the research tax credit, and a total of \$1.1 million was reported as tax credit in the State of Hawaii. Significantly, over 75% of the 280 full time employees earned over \$60,000 and 35% earned over \$100,000. Expanding the credit would provide greater support to these companies and allow other companies to participate.

HTDC is supportive of policies that extend benefits and incentives to R&D companies that are moving toward commercialization. The tax credit, as one part of a comprehensive economic development policy supporting innovation, can be effective.

Thank you for the opportunity to offer these comments.



Written Statement of
DR. PATRICK K. SULLIVAN
PRESIDENT/CEO OCEANIT

Before the

HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS

February 3, 2015

9:00 a.m.

State Capitol, Conference Room 312

In Support of

HB1068 RELATING TO HIGH TECHNOLOGY

To: Chair Derek S.K. Kawakami, Vice Chair Sam Satoru Kong, and Members of the Committee

From: Dr. Patrick K. Sullivan, President/CEO

Re: Testimony in Support of HB1068

Honorable Chair, Vice-Chair and Committee Members:

Thank you for the opportunity to submit testimony **in support of HB1068**

Oceanit currently employs about 125 scientists, engineers and support staff. We regularly host interns, school classes, and conduct numerous outreach activities for elementary thru college levels students to introduce them to science and engineering careers. We let the children of Hawai'i know that there are exciting, good paying jobs for them in right here in this State. Many of them have returned to the islands, equipped with college degrees, wanting to work in science and engineering. It is our hope that we can continue to offer an alternative to those 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 future growth. The reality is that without the R&D tax credit, Oceanit would not have been able to make these investments.

As a result of forward-looking nature of research, few R&D investments have short-term rewards. This bill would re-establish a temporary refundable 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.

Thank you for your continued support of R&D as the stimulant to an innovative Hawai'i STEM economy that Hawai'i's future generation can be apart of.

TAXBILLSERVICE

126 Queen Street, Suite 304

TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Tax credit for research activities

BILL NUMBER: HB 1068

INTRODUCED BY: Kawakami, Cullen, McKelvey, Oshiro, Say, Tokioka and 2 Democrats

BRIEF SUMMARY: Amends HRS section 235-110.91 to reinsert the phrase “provided that references to the base amount shall not apply and credit for all qualified research expenses may be taken without regard to the amount of expenses for previous years.”

EFFECTIVE DATE: July 1, 2015; applicable to tax years beginning after December 31, 2015

STAFF COMMENTS: The legislature by Act 270, SLH 2013, reestablished the income tax credit for qualified research activities that expired on 12/31/10. The prior version of that law, under Act 221, SLH 2001, offered a credit for qualified research activities that was a flat percentage of qualified research expenses in Hawaii without regard to the federal base amount (the federal credit is supposed to be an incentive to increase research activities, so the federal credit is based on incremental research expenses). When Act 270 brought the credit back, it did so as an incremental credit, similar to the federal credit. The proposed measure brings the Act 221 version of the research credit back, so all qualified research expenses in Hawaii (the restriction to Hawaii is not in the bill, but is in section 235-110.91(f) in the existing law) would be eligible for the credit regardless of any base amount. This change could result in a drain of the state’s financial resources.

Substantively, over the last decade, Hawaii has adopted various tax incentives to encourage the development of high technology businesses in the state. The acts provided investment and research credits as well as income exclusions providing tax relief to high tech businesses and individuals associated with high tech businesses. 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 plow money into such activities is the fact that the credit provides a way to avoid paying state taxes.

Digested 2/2/15



To: HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS

February 3, 2015 9:00 a.m.

State Capitol, Conference Room 312

In **SUPPORT** of **HB1068 RELATING TO HIGH TECHNOLOGY**



From: Vincent Kimura, Managing Partner, Inovi Technologies

Honorable Chair Kawakami, Vice-Chair Kong and Members of the Committee:

This is my testimony in **STRONG SUPPORT** of **HB 1068**.

The future of technology and innovation in Hawaii rests on the quality of STEM education found in Hawaii's education system. Over the past 5 years we have worked hand-in-hand with dozens of technology companies in Hawaii. The movement of the technology industry has made significant strides toward achieving the goal of diversifying Hawaii's economy. Hawaii's technology industry needs the support of economic growth and diversification of our economy, creating good paying jobs and reducing the "brain drain" that has afflicted our state for far too long. This must be a priority if we are to have a future.

We **STRONGLY SUPPORT HB 1068**, which would allow a credit for all qualified research expenses without regard to the amount of expenses for previous years. This R&D credit has and we hope will continue to jump start many of our company innovations as it directly impacts job creation.

Respectfully submitted,

Vincent Kimura

L A T E



Written Statement of Seibert Murphy, CEO, Guide Star Engineering, LLC

Before the
HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS
February 3, 2015
9:00 a.m.
State Capitol, Conference Room 312
In Support of
HB1069 RELATING TO HIGH TECHNOLOGY

Honorable Chair Kawakami, Vice-Chair Kong and Members of the Committee:

Thank you for the opportunity to submit testimony in STRONG SUPPORT of HB ~~1069~~. 1068

The technology industry in Hawaii has grown significantly over the years and is a qualified success in helping to diversify Hawaii's economy. Part of that success is due to activities as a result of the Small Business Innovation Research (SBIR) grant program.

The program encourages and funds early stage ideas and innovations. While Phase I funding under the program has provided support for research activities of fledgling Hawaii companies, its use is limited to research. It does not provide any funds for these companies to move past the research and development (R&D) stage onto the commercialization stage. That is why I petition the State to make a bold step and back the technology businesses community by passing this legislation.

I STRONGLY SUPPORT HB 1069, which would expand the state matching funds for Phases II and III of the federal SBIR program to provide support for the commercialization activities of local start-up companies like ours. Not only would this expansion of funding increase the level of federal monies to our State, it would go far in ensuring that our keiki have good paying jobs here at home and their impact will be felt across the globe.

Again, thank you for the opportunity to testify.

Sincerely,

Seibert Murphy
CEO

LATE

LATE

Written Statement of
DAVID G. WATUMULL, PRESIDENT/CEO
CARDAX, Inc.

Before the
HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS
February 3, 2015
9:00 a.m.
State Capitol, Conference Room 312
In Support of
HB1068 RELATING TO HIGH TECHNOLOGY

To: Chair Derek S.K. Kawakami, Vice Chair Sam Satoru Kong, and Members of the Committee

From: David G. Watumull, President and CEO, Cardax, Inc.

Re: Testimony in Support of HB1068

Honorable Chair, Vice-Chair and Committee Members:

Thank you for the opportunity to submit testimony **in support of HB1068**

Cardax, Inc. is a Hawaii based biopharmaceutical company developing a new class of anti-inflammatory consumer and pharmaceutical products. It has raised more than \$36 million for its technology since 2002, including more than \$1 million in SBIR funding, and has recently gone public. Its partners include the world's largest chemical company, BASF, and Pfizer spin-out Capsugel.

This Bill is important to the technology community because the SBIR program has proven to be a crucial source of funding for innovation in Hawaii. But, SBIR funding does not provide companies with the funds to cover the expenses of writing the "next" grant and this bill would provide much needed support for this function. The bill leverages existing research work and expands the potential for future grant or contract awards.



Written Statement of Michael Pfeffer, CEO, Ibis Networks

Before the
HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS
February 3, 2015
9:00 a.m.
State Capitol, Conference Room 312
In Support of
HB1068 RELATING TO HIGH TECHNOLOGY

LATE

Honorable Chair Kawakami, Vice-Chair Kong and Members of the Committee:

Thank you for the opportunity to submit testimony in **STRONG SUPPORT** of **HB 1068**, which would expand Hawaii's existing Research and Development (R&D) tax credit in a responsible and effective manner that would give local companies the resources to build and grow businesses based on technologies that they have developed.

By eliminating the incremental requirement for credits, companies like Ibis Networks will have access to resources that are currently unavailable to most start-ups in Hawaii, thereby allowing fledgling companies like us to take our product to market more quickly than we are currently able to do.

Additionally, a modified R&D tax credit law would have the secondary benefit of enabling Hawaii companies to hire more local people, increase their chances of winning Small Business Innovation Research (SBIR) grants, and secure the capital to acquire loans and other potential funds.

A spin-off of Oceanit, Ibis Networks is but one example of the many local fledgling companies that would be able to capitalize on the opportunity the passage of this measure would provide.

This is why we **STRONGLY SUPPORT HB 1068**. I thank you again for the opportunity to testify.