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**STATE OF HAWAII
DEPARTMENT OF TAXATION**

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To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Friday, March 15, 2019
Time: 2:00 P.M.
Place: Conference Room 308, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

Re: S.B. 1314, S.D. 1, Relating to Tax Credits

The Department of Taxation (Department) provides the following comments regarding S.B. 1314, S.D. 1, for your consideration.

S.B. 1314, S.D. 1, extends the Tax Credit for Research Activity Tax Credit (TCRA) through 2024 and deletes conformity to the provisions relating to the base amount contained in section 41 of the Internal Revenue Code (IRC), such that the credit can be taken without regard to the amount of expenses incurred in the previous years. The measure has a defective effective date of July 1, 2050, but would otherwise apply to taxable years beginning after December 31, 2019.

The Department recognizes the importance of encouraging research and development, which in turn creates new jobs and greater prosperity for the State. However, the Department has serious concerns due the anticipated administrative and enforcement issues, including expensive and protracted litigation. Although this measure would adopt the federal requirements set forth under IRC section 41, there is no requirement that the taxpayer actually claim the federal tax credit in order to qualify for the State credit. The Department firmly believes that a taxpayer should be required to claim the federal credit under IRC section 41 in order to claim the State credit. Requiring the taxpayer to make the federal tax claim will greatly assist the Department in insuring that qualified research is actually being performed.

The TCRA is a highly technical and complex credit. "Qualified research" for purposes of this credit must meet all of the following conditions:

1. The expenditures can be treated as expenses under section 174, (also known as the section 174 test);
2. The research is undertaken for the purpose of discovering information which is

- technological in nature, (also known as the discovering technological information test);
3. The application of which is intended to be useful in the development of a new or improved business component of the taxpayer (also known as the business component test); and
 4. Substantially all of the activities of which constitute elements of a process of experimentation for a qualified purpose (also known as the process of experimentation test).

Past experience has been that the research credit is prone to substantial abuse, is very costly to the State, and has generated costly and intensive litigation over the tax credit requirements. These issues are particularly pronounced where the state tax law is inconsistent with the federal tax law. The Internal Revenue Service (IRS) has far greater expertise in the subject matter and the resources to determine and resolve which expenses qualify for this tax credit. The IRS also has experts on hand to determine whether claimed research qualifies for the credit. The Department is better able to ensure taxpayer compliance when the state tax law conforms with federal law. Conformity to the federal law allows the Department to rely on the IRS's greater expertise and resources.

For example, although the federal research credit has allowed costs developing internal use software to qualify for the credit since 1986, the IRS to date has been unable to finalize regulations on the matter. The end result is extremely protracted litigation as to whether software is for internal use or not. It is not uncommon for IRS litigation to exceed ten years before a final court decision on the matter is entered.

Because this measure will eliminate conformity to IRC section 41, a taxpayer will be able to claim the State TCRA even though it is not claiming the federal credit. For example, a taxpayer may not have incurred expenses over the base amount and will not be able to claim the federal credit. However, because this measure makes the base amount inapplicable for purposes of the State TCRA, the taxpayer will be able to claim the State credit, and the taxpayer's federal return and the Hawaii return will not match.

Thank you for the opportunity to provide comments.



Written Statement of
Len Higashi
Acting Executive Director
Hawaii Technology Development Corporation
before the
House Committee on Finance
Friday, March 15, 2019
2:00 p.m.
State Capitol, Conference Room 308

In consideration of
SB1314, SD1
RELATING TO TAX CREDITS.

Chair Luke, Vice Chair Cullen, and Members of the Committee.

The Hawaii Technology Development Corporation (HTDC) submits **comments** on SB1314, SD1 that amends the research activity tax credit so that references to the base amount in section 41 of the Internal Revenue Code shall not apply, and credit for all qualified research expenses may be taken without regard to the amount of expenses for previous years, and extends the research activity tax credit through 2024, and applies to taxable years beginning after 12/31/2019.

HTDC does not take a position on the bill. In discussions with representatives from DOTAX and DBEDT – READ, it was pointed out that although the current statute requires the company to complete the DBEDT survey, it does not have a mechanism to ensure the survey is completed. Thus, not all companies are completing the survey. Also, the DBEDT survey deadline is currently set at June 30, while companies that file extensions submit their returns on October 20. We suggest that the deadline for filing DBEDT survey be removed so companies can file the DBEDT survey year-round. We suggest that these gaps be addressed if the credits are continued.

From HRS 235-11.91

“(i) A qualified high technology business that claims the credit under this section shall complete and file with the Department of Business, Economic Development, and Tourism, through that department’s website, an annual survey on electronic forms prepared and prescribed by the Department of Business, Economic Development, and Tourism. The annual survey shall be filed before June 30 of each calendar year following the calendar year in which the credit may be claimed under this section. The Department of Business, Economic Development, and Tourism may adjust the due date of the annual survey by rules adopted pursuant to chapter 91.”

Thank you for the opportunity to offer these comments.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Increase Tax Credit for Research Activities

BILL NUMBER: SB 1314, SD-1

INTRODUCED BY: Senate Committee on Ways & Means

EXECUTIVE SUMMARY: This language harkens back to Act 221, SLH 2001. Can we afford such generous incentives?

SYNOPSIS: 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.” This would convert the credit for increasing research activities to a credit for research activities whether or not the amount has increased.

Amends the sunset date of the credit from Dec. 31, 2019 to Dec. 31, 2024.

EFFECTIVE DATE: July 1, 2050.

STAFF COMMENTS: The legislature by Act 270, SLH 2013, reestablished the income tax credit for qualified research activities that expired on Dec. 31, 2010. 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, like the federal credit.

Under current law, the state credit is 100% of the federal credit, but the qualified research expenses on which the credit is based are not to include research expenses incurred outside of Hawaii. In addition, the credit must be claimed by a qualified high technology business as defined in HRS section 235-7.3(c).

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.

Re: SB 1314, SD-1
Page 2

At a minimum, lawmakers should carefully examine the results that have come out of this 20-year-old incentive to see if the State has gotten its money's worth. If it hasn't, how can an extension or increase in the credit be justified?

Digested 3/12/2019



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

Before the

HOUSE COMMITTEE ON FINANCE

March 15, 2019

2:00 p.m.

State Capitol, Conference Room 308

In Support of

SB1314 RELATING TO TAX CREDITS

To: Chair Representative Sylvia Luke, Vice Chair Representative Ty J.K. Cullen
and Members of the Committee

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

Re: **Testimony in Support of SB1314**

Honorable Chair, Vice-Chair and Committee Members:

Thank you for the opportunity to submit testimony **in support of SB1314**

Oceanit is a home grown, Hawaii-based, ***Mind to Market*** company that develops technology from fundamental science and research, and drives original product offerings to markets in energy, aerospace and healthcare, creating spin-out companies and partnering with end users. We employ just under 200 professionals and 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.

R&D credits help start and foster Hawaii's tech industry, which is in its infancy. 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. It's the underpinning of Hawaii's emerging tech and innovation economy, creating jobs in STEM fields that are essential to Hawaii's future.





Chamber of Commerce HAWAII

The Voice of Business

**Testimony to the House Committee on Finance
Friday, March 15, 2019 at 2:00 P.M.
Conference Room 308, State Capitol**

RE: SB 1314, SD1 RELATING TO TAX CREDITS

Chair Luke, Vice Chair Cullen, and Members of the Committee:

The Chamber of Commerce Hawaii ("The Chamber") **supports** SB 1314 SD1, which amends the research activity tax credit so that references to the base amount in section 41 of the Internal Revenue Code shall not apply, and credit for all qualified research expenses may be taken without regard to the amount of expenses for previous years. This bill would also extend the research activity tax credit through 2024 and applies to taxable years beginning after December 31, 2019.

The Chamber is Hawaii's leading statewide business advocacy organization, representing about 2,000+ 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 continues to support the State's efforts to promote and foster innovation research and development in Hawaii. Innovation is a proven catalyst for economic growth and the creation of high-skilled and high-paying jobs. This bill would help to provide necessary capital to help assist these small businesses in innovation research and expansion and provide support to grow their businesses and compete globally.

Thank you for the opportunity to testify.

SB-1314-SD-1

Submitted on: 3/14/2019 1:28:59 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Isar Mostafanezhad	Nalu Scientific, LLC	Support	No

Comments:

As founder and CEO of Nalu Scientific, I would like to note my strong support for SB1314 for R&D Tax Credits. Hawaii has one of the highest of living costs in the nation and that adds to the cost of doing business in the state. Allowing technology companies benefit from an R&D Tax credit will help offset some cost and allow such companies re-invest those dollars into a next generation product or service that can bring in more funding to the state. Please do not hesitate to contact me if you need more information on this matter.

SB-1314-SD-1

Submitted on: 3/13/2019 8:25:41 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Ryan Bradley	Hawaii Aerospace Corp	Support	No

Comments:

Written Statement of

Ryan Bradley, President

Hawaii Aerospace

Before the

HAWAII COMMITTEE ON FINANCE

March 15, 2019

2:00 p.m.

State Capitol, Conference Room 308

In Support of

SB1314 RELATING TO TAX CREDITS

To: Chair Representative Sylvia Luke, Vice Chair Representative Ty J.K. Cullen, and Members of the Committee

From: Ryan Bradley, President of Hawaii Aerospace

Re: Testimony in Support of SB1314

Honorable Chair, Vice-Chair and Committee Members:

Hawaii Aerospace is a local company in Kaimuki, Hawaii that maintains an agile team of well-trained and motivated Scientists, Engineers, Technicians and Craftsman that offers a wide range of services including design and development of custom scientific instrumentation, engineering support, integration and custom manufacturing.

The R&D credit will bring more jobs to Hawaii as well as many long-term investments to Hawaii's economy. This bill would re-establish a refundable R&D income tax credit for qualified research activities in the State of Hawai'i, to help provide longer-term continuity for Hawaii's tech industry.

Thank you for the opportunity to submit testimony **in support of SB1314**

SB-1314-SD-1

Submitted on: 3/14/2019 12:57:44 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Brian Dote	Tapiki	Support	No

Comments:

SB-1314-SD-1

Submitted on: 3/14/2019 2:15:46 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Michael Pfeffer	Gabriel Health, Inc	Support	No

Comments:

I am a strong supporter of this bill and it will help bring more companies like Gabriel Health to Hawaii.

SB-1314-SD-1

Submitted on: 3/14/2019 11:59:52 AM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Stacy Ferreira	Individual	Support	No

Comments:

SB-1314-SD-1

Submitted on: 3/14/2019 12:02:48 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Kent Tsukamoto	Individual	Support	No

Comments:

As a CPA who works with technology companies, I fully support innovation and incentives to perform research in Hawaii. I support this bill and ask you to advance it.

Kent K. Tsukamoto, CPA

LATE

SB-1314-SD-1

Submitted on: 3/14/2019 3:39:04 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Omar Sultan	Individual	Support	No

Comments:

LATE

SB-1314-SD-1

Submitted on: 3/14/2019 4:55:14 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Edward Ontai	DataHouse Consulting, Inc	Support	No

Comments:

LATE

SB-1314-SD-1

Submitted on: 3/14/2019 3:57:46 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Maggie Hamamoto	Individual	Support	No

Comments:

LATE

SB-1314-SD-1

Submitted on: 3/14/2019 8:47:37 PM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Christine Ajirogi	Individual	Support	No

Comments:

LATE

SB-1314-SD-1

Submitted on: 3/15/2019 6:58:39 AM

Testimony for FIN on 3/15/2019 2:00:00 PM

Submitted By	Organization	Testifier Position	Present at Hearing
Aaron A Kagawa	Individual	Support	No

Comments:

SB-1314-SD-1

Submitted on: 3/15/2019 7:24:06 AM

Testimony for FIN on 3/15/2019 2:00:00 PM



Submitted By	Organization	Testifier Position	Present at Hearing
Ann Chung	Individual	Support	Yes

Comments:

I strongly SUPPORT HB1314. The original bill was passed in 2013 as Act 270 to support companies doing research and development in Hawaii. The Act sunsets at the end of 2019. Supporting this bill helps Hawaii's R&D companies enabling them to continue spending monies on wages, materials and subcontractors IN THE STATE OF HAWAII and recognizes the importance of Hawaii's innovation industries to our economy. I strongly urge you to pass this bill and extend the sunset date. Mahalo for the opportunity to testify.