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**STATE OF HAWAII
DEPARTMENT OF TAXATION**

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To: The Honorable Donovan M. Dela Cruz, Chair
and Members of the Senate Committee on Ways and Means

Date: Wednesday, February 20, 2019
Time: 10:00 A.M.
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

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

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

S.B. 1314 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 is effective upon approval.

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 to the anticipated administrative and enforcement issues, including expensive and protracted litigation. 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 TCRA. 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 ensuring 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 constitutes 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 for 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.

Finally, the Department notes that this measure is effective upon approval. This effective date means that a taxpayer's taxable year will be bifurcated, with a portion of the year governed by the statute as it now exists and the remainder governed by this statute. This creates a substantial compliance issue for the Department. The Department strongly recommends that the measure be made effective for taxable years beginning after December 31, 2019.

Thank you for the opportunity to provide comments.

SB-1314

Submitted on: 2/18/2019 9:57:25 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Melodie Aduja	Testifying for O`ahu County Committee on Legislative Priorities of the Democratic Party of Hawai`i	Support	No

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

INTRODUCED BY: J. KEOHOKALOLE, Fevella, Inouye, Kim, Taniguchi, Wakai

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: Upon approval.

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, 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

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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 2/17/2019



Written Statement of
Len Higashi
Acting Executive Director
Hawaii Technology Development Corporation
before the
Senate Committee on Ways and Means
Wednesday, February 20, 2019
10:00 a.m.
State Capitol, Conference Room 211

In consideration of
SB1314
RELATING TO TAX CREDITS.

Chair Dela Cruz, Vice Chair Keith-Agaran, and Members of the Committee.

The Hawaii Technology Development Corporation (HTDC) submits **comments** on SB1314 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.

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.



Statement of
Hermann Kugeler
Business Development Manager
Makai Ocean Engineering, Inc.
before the
Senate Committee on Ways and Means
Wednesday February 20th, 2019
10:00am
State Capitol, Conference Room 211
In consideration of
SB1314
RELATING TO TAX CREDITS

Chair Dela Cruz, Vice Chair Keith-Agaran, and members of the Committee

Makai Ocean Engineering, Inc. **SUPPORTS SB1314** that decouples the federal base amount in section 41 of the Internal Revenue Code, and extends the research activity tax credit through 2024.

Makai is a locally-owned and operated technology company based in Hawai`i for over 45 years. We are currently performing R&D on a variety of exciting ocean technology projects, including autonomous underwater vehicles, ocean thermal energy conversion (OTEC) and seawater air conditioning (SWAC) systems, submarine and subsea cable systems, and a Department of Energy project to grow and harvest macroalgae offshore in Hawaiian waters to produce a renewable biofuel alternative for transportation.

Makai has been successful in bringing in tens of millions of dollars in R&D funds from federal and international sponsors to Hawai`i, helping to stem the tide of “brain drain” of talented kama`aina kids going to the mainland. Makai is not unique among Hawaii technology companies in this. There is a tech community here that has made a strong economic impact in terms of high paying jobs, and demonstrated success in commercializing federal R&D, which has increased taxable revenue for the state, and brought home kama`aina scientists and engineers.

This bill would enhance the ability of Hawaii companies like Makai to outshine mainland peers in competitive federal R&D projects, bring home R&D dollars that greatly exceed the



initial investment, and create a critical mass and a truly vibrant industry of innovative R&D companies in Hawaii. It would expand and diversify Hawaii's economy, and enable our tech industry to support high-paying, highly-skilled professional jobs for our keiki here at home.

This is why we **SUPPORT SB1314**, which supports 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.

Thank you for the opportunity to testify.



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

Before the

SENATE COMMITTEE ON WAYS AND MEANS

February 20, 2019

10:00 a.m.

State Capitol, Conference Room 415

In Support of

SB1314 RELATING TO TAX CREDITS

To: Chair Senator Donovan Dela Cruz, Vice Chair Senator Gilbert Keith-Agaran
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.

SB-1314

Submitted on: 2/16/2019 4:41:04 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

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.

LATE

SB-1314

Submitted on: 2/19/2019 11:13:03 AM

Testimony for WAM on 2/20/2019 10:00:00 AM

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

Comments:

Written Statement of

Ryan Bradley, President

Hawaii Aerospace Corporation

Before the

SENATE COMMITTEE ON WAYS AND MEANS

February 20, 2019

10:00 a.m.

State Capitol, Conference Room 415

In Support of

SB1314 RELATING TO TAX CREDITS

To: Chair Senator Donovan Dela Cruz, Vice Chair Senator Gilbert Keith-Agaran, 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 Corp 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**

LATE

SB-1314

Submitted on: 2/19/2019 5:35:06 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

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

Comments:

As a long time entrepreneur in Hawaii I strongly support this bill as it helps to promote and retain high technology businesses in Hawaii.

LATE

SB-1314

Submitted on: 2/19/2019 5:42:57 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Keith T Matsumoto	Individual	Support	No

Comments:

LATE

SB-1314

Submitted on: 2/19/2019 5:49:54 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Miki K. Tomita	Individual	Support	No

Comments:

LATE

SB-1314

Submitted on: 2/19/2019 7:13:44 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Burt Lum	Individual	Support	No

Comments:

LATE

SB-1314

Submitted on: 2/19/2019 7:42:34 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Kevin Hause	Individual	Support	No

Comments:

supporting investment and research in the state not only keeps local companies from leaving, but also encourages STEM education and helps our smartest students home after high school or college.

If Hawaii is serious about expanding our business base beyond hospitality and military, we absolutely must work to create incentives and an ecosystem that encourages investment in other areas.

LATE

SB-1314

Submitted on: 2/19/2019 8:28:42 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

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

Comments:

LATE

SB-1314

Submitted on: 2/19/2019 8:44:21 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

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

Comments:

LATE

SB-1314

Submitted on: 2/19/2019 8:46:19 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Josh Reppun	Individual	Support	No

Comments:

I fully support SB1314. Innovation and intellectual property that drives value creation/capture comes from Research & Development (R&D) that is performed by Hawaii's small businesses of all kinds. The credit is attractive because companies must do at least 50% of the R&D in Hawaii, and thus, must do the work first before they can claim the credit. What qualifies as R&D is determined by the IRS so this eliminates who qualifies for the credit, which reduces the load on State DoTax. I FULLY SUPPORT THIS CONCEPT. ~ Josh Reppun

LATE

SB-1314

Submitted on: 2/19/2019 10:18:40 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

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

Comments:

I would like to express my strong support for providing R&D tax credits which will help businesses re-invest in innovation which subsequently will not only boost the economy but will also create new products and services through the value-add mechanism. Innovation and technology based economy is in its infancy in Hawaii and needs support from many players including bills that will encourage such companies to fund additional internal R&D. Hawaii is on top of the charts when it comes to cost of doing business, and as a founder of a technology company I believe SB1314 is a good step forward (among many needed) to help small business innovative companies. .

LATE

SB-1314

Submitted on: 2/19/2019 10:45:15 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
VINCENT KIMURA	Testifying for Smart Yields	Support	No

Comments:

LATE

SB-1314

Submitted on: 2/20/2019 6:54:45 AM

Testimony for WAM on 2/20/2019 10:00:00 AM

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

Comments:

LATE

SB-1314

Submitted on: 2/20/2019 9:55:04 AM

Testimony for WAM on 2/20/2019 10:00:00 AM

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

Comments:

LATE

SB-1314

Submitted on: 2/20/2019 2:52:11 PM

Testimony for WAM on 2/20/2019 10:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Ryan Kanno	Individual	Support	No

Comments: