



**TESTIMONY OF
THE DEPARTMENT OF THE ATTORNEY GENERAL
THIRTIETH LEGISLATURE, 2020**

ON THE FOLLOWING MEASURE:

S.B. NO. 3035, RELATING TO TAXATION.

BEFORE THE:

SENATE COMMITTEE ON ENERGY, ECONOMIC DEVELOPMENT, AND TOURISM

DATE: Friday, February 7, 2020

TIME: 2:50 p.m.

LOCATION: State Capitol, Room 414

TESTIFIER(S): Clare E. Connors, Attorney General, or
Cynthia M. Johiro, Deputy Attorney General

Chair Wakai and Members of the Committee:

The Department of the Attorney General has concerns about this bill and provides the following comments.

The purpose of S.B. 3035 is to “establish an ocean science research tax credit to foster research and development to expand and diversify Hawaii’s economy. See S.B. 3035, Page 2, lines 3-5. A “qualified entity” would be entitled to this research tax credit so long as it is a “small business in the State of Hawaii, which has been doing business for at least five years having the principal purpose of research and development in the field of ocean sciences as defined by the National American Industry Classification System code 541715.” Id., Page 5, lines 1-5. (Emphasis added).

This bill may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

The Commerce Clause provides that “[t]he Congress shall have Power . . . [t]o regulate Commerce . . . among the several States.” U.S. Const. art. I, § 8, cl. 3. “Though phrased as a grant of regulatory power to Congress, the clause has long been understood to have a ‘negative’ aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce.” *Oregon Waste Sys., Inc. v. Dep’t of Env’tl. Quality*, 511 U.S. 93, 98 (1994). A tax on interstate commerce will be sustained “when the tax is applied to an activity with a substantial

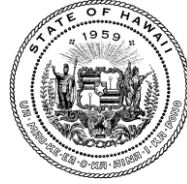
nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). If a tax discriminates against interstate commerce by providing "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter," the tax will be *per se* invalid unless the tax "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." *Oregon Waste*, 511 U.S. at 99, 101.

This bill can be interpreted as allowing the tax credit to be claimed only by small businesses located in the State and not by small businesses located out-of-state, exposing it to challenge under the Commerce Clause of the United States Constitution.

Based on the foregoing, we respectfully ask that these concerns be addressed. One way to do so is to remove the phrase "in the State of Hawaii" from the definition of "qualified entity" so that both in-state and out-of-state small businesses who have been doing business for at least five years qualify for the tax credit.

DAVID Y. IGE
GOVERNOR

JOSH GREEN M.D.
LT. GOVERNOR



RONA M. SUZUKI
DIRECTOR OF TAXATION

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION

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To: The Honorable Glenn Wakai, Chair;
The Honorable Brian T. Taniguchi, Vice Chair;
and Members of the Senate Committee on Energy, Economic Development, and
Tourism

From: Rona M. Suzuki, Director
Department of Taxation

Re: S.B. 3035, Relating to Taxation

Date: Friday, February 7, 2020

Time: 2:50 P.M.

Place: Conference Room 414, State Capitol

The Department of Taxation (Department) provides the following comments regarding S.B. 3035.

S.B. 3035 establishes the ocean sciences research tax credit up to an unspecified amount. The measure is effective upon approval and applies to taxable years beginning after December 31, 2019, but not to taxable years beginning after December 31, 2025.

The Department first notes that proposed section (b) determines the credit based on the **investment** into an entity that does research that meets National American Industry Classification System (NAICS) code 541715. Substantial credit could thus be generated by simply investing in an entity, regardless of how much research is actually performed. The high technology business investment tax credit (QHTB credit) codified at section 235-110.9, Hawaii Revised Statutes (HRS), also allowed for a tax credit based on investment rather than the actual activity that the State intended to incentivize. The Department suggests amending the measure so that qualification for the credit is contingent on more than just an investment.

In addition, unlike the QHTB credit, S.B. 3035 does not require the investment to actually be at-risk. The Department suggests adding a provision to this measure specifying that the investment be at-risk. This will help to reduce any sham investments that do not effectuate the purpose of the credit.

The Department notes further that NAICS Code 541715 is very broad and therefore overlaps with several existing credits, including the ship repair industry tax credit under section 235-110.65, HRS, and the tax credit for research activities under section 235-110.91, HRS. To prevent double-dipping, the Department strongly suggests adding a new subsection to read:

(h) No other credit under this chapter shall be claimed for expenses or costs paid with an investment made into a qualified entity for which the credit was

claimed under this section.

The Department also suggests clarification of the definition of “qualified entity.” As currently written, a “qualified entity” is a small business in the State of Hawaii. The term “small business” needs to be defined because the term is ambiguous and is not a defined term in chapter 235, HRS. In addition, “in the State of Hawaii” should be clarified because providing the new credit only for entities physically located in Hawaii is likely to violate the Commerce Clause of the U.S Constitution.

Finally, the Department respectfully requests that this new credit be made available for taxable years beginning after December 31, 2020. This will prevent retroactive availability of the credit and allow sufficient time to make the necessary form and computer system modifications.

Thank you for the opportunity to provide comments.



Statement of
Hermann Kugeler
Business Development Manager
Makai Ocean Engineering, Inc.
before the
Senate Committee on Energy, Economic Development & Tourism
Friday, February 7, 2020
2:50pm
State Capitol, Conference Room 414
In consideration of
SB3035
RELATING TO TAXATION.

Chair Wakai, Vice Chair Taniguchi, and Members of the Committee.

Makai Ocean Engineering, Inc. **STRONGLY SUPPORTS SB3035** that establishes the ocean sciences research tax credit.

Makai Ocean Engineering, Inc. is a locally-owned and operated technology company based in Hawaii for over 45 years. Makai has been focused on advancing ocean sciences in the state since its inception in 1973. Hawaii's access to the ocean provides Makai and others in the industry with a distinct advantage that sets us apart from our mainland competitors. With the resources available to us, Makai has the potential to become a world leader in ocean technology.

Makai is currently performing R&D and working towards commercialization of ocean thermal energy conversion (OTEC) at the Natural Energy Laboratory of Hawai'i Authority (NELHA) in Kailua-Kona. Makai employs eight highly-paid, highly-skilled engineers and scientists in the high tech ocean science field in rural Kailua-Kona. This program has achieved a huge milestone of connecting to the grid, making Hawai'i the home of the world's largest operational OTEC plant, and the clear leader in ocean thermal energy. Other innovative ocean tech similar to this is being developed in the islands by Makai and a few other small businesses.

Makai's Waimanalo office employs 21 additional engineers that develop both hardware and software systems that are used by federal and commercial clients around the world. Makai has been able to secure additional competitively awarded federal funding from the Departments of Defense and Energy, and bring home national honors, such as the Small Business Administration's Tibbetts Award. This national award recognizes the very best in small innovative companies in the country whose technologies have made a strong economic impact in terms of high paying jobs, and demonstrating success in actually commercializing federal R&D and increasing taxable revenue for the state.

This tax credit would attract local investment in ocean science companies like Makai, and allow our business and the rest of the industry to grow. Like the tech giants in the Bay Area of California that grew from investment capital, this tax credit would assist Hawaii in meeting its potential and become the leader in ocean science research and development.



This is why we **STRONGLY SUPPORT SB3035**, which would establish the ocean science research tax credit, and increase investment in Hawaii's ocean science industry. Not only would this tax credit increase investments in local companies by Hawaii residents, it would enable the ocean sciences industry in Hawaii to gain investment capital that will allow the companies to grow and provide more highly-skilled professional jobs for our keiki here at home.

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, Ocean Sciences Research Tax Credit

BILL NUMBER: SB 3035

INTRODUCED BY: KIDANI, K. RHOADS, Baker, Kanuha, Shimabukuro

EXECUTIVE SUMMARY: Establishes the ocean sciences research tax credit.

SYNOPSIS: Adds a new section to chapter 235 to establish a nonrefundable tax credit for investment into a “qualified entity” for research and development in the field of ocean sciences. The amount of the credit is ___% of the investment made into the qualified entity, up to \$____. Amounts in excess of the limit can be carried forward.

Requires any taxpayer claiming the credit to submit information to the Department of Taxation within 90 days of the end of the calendar year in which the credit is properly claimable. Failure to timely submit the information shall be subject to a penalty of \$5,000 per month or a fraction thereof, not to exceed \$25,000.

All claims, including amended claims, for this tax credit shall be filed on or before the end of the twelfth month following the close of the taxable year for which the credit may be claimed. Failure shall constitute a waiver of the right to claim the credit.

The credit shall not apply to taxable years beginning after Dec. 31, 2025.

Defines “qualified entity” as a small business in the State of Hawaii, which has been doing business for at least five years having the principal purpose of research and development in the field of ocean sciences as defined by the National American Industry Classification System code 541715.

EFFECTIVE DATE: This Act, upon its approval, shall apply to taxable years beginning after December 31, 2019.

STAFF COMMENTS: This bill contains many technical issues. Among them:

- Subsection (b)(1) allows the credit for investment into the qualified entity “for research and development in the field of ocean sciences.” Normally when funds are invested in an entity it is up to the entity how to use them, and investors usually are not informed except in general terms (such as in financial statements issued by the entity). As written, no investor could ever be allowed the credit because they would not be able to prove the extent of that investor’s investment that was used for research and development.
 - It would be desirable to remove the specified clause, trusting that an eligible entity as defined will spend an appropriate amount on R&D given that R&D in ocean science is its primary business.

- Because the credit is for investment into the qualified entity, an entity's partners or members would be able to claim the credit but the entity itself could not. Yet subsections (b)(1) and (2) contain language that presuppose that the entity itself can claim credit.
 - It may be preferable to remove references to the qualified entity claiming credit.
- Taxpayers claiming the credit need to submit information to the Department by the end of March, even before the unextended due date of the income tax return, under pain of severe penalties. Taxpayers may be in for some nasty surprises, including owing more than they would if no credit claim was made, if they are foolish enough to attempt to claim this credit without having submitted the pre-claim in March or earlier.
 - Rather than impose the penalty, it may be preferable to simply disallow the credit.

Digested 2/4/2020



NATURAL ENERGY LABORATORY OF HAWAII AUTHORITY

An Authority of the State of Hawaii attached to the Department of Business, Economic Development & Tourism

Statement of
Gregory P. Barbour
Executive Director
Natural Energy Laboratory of Hawaii Authority
before the

SENATE COMMITTEE ON ENERGY, ECONOMIC DEVELOPMENT, AND TOURISM

Friday, February 07, 2020
2:50 pm
State Capitol, Conference Room 414

in consideration of
S.B. 3035
RELATING TO TAXATION.

The Natural Energy Laboratory of Hawaii Authority (NELHA) supports the intent and is pleased to comment on S.B. 3035 which would create an income tax credit for Hawaii businesses whose principal purpose is research and development in the field of ocean sciences for at least five years. This makes good business sense as Hawaii is a large ocean state and offers comparative advantages for businesses in this field.

NELHA administers the 900-acre Hawaii Ocean Science and Technology Park (HOST Park) in Kailua-Kona on the Island of Hawaii. Last year we created, with the Legislative support, an aquaculture accelerator operated by HATCH focused on global innovation for technologies in

ocean science. This accelerator has been very successful and recently completed its first cohort of 13 companies. We are in discussions regarding new leases at HOST Park with two of the companies from the HATCH accelerator and one company in a similar field which just completed the Elemental Accelerator. In this regard, providing tax credits for these types of businesses will assist us in our “investment attraction” mission for the State of Hawaii economic development programs and grow our economy.

The policy position is from NELHA which is from an economic development position and does not take into consideration the tax, fiscal and revenue policy, as it relates to the State of Hawaii, for that we defer to the Departments of Taxation and Budget and Finance.

Thank you for the opportunity to offer these comments.

SB-3035

Submitted on: 2/6/2020 12:12:22 PM

Testimony for EET on 2/7/2020 2:50:00 PM

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

Comments:

I strongly support SB3035. There are many companies in Hawaii doing great research and engineering , creating high-paying, high-skilled jobs, and bringing in significant amounts of federal funding. Research and engineering can be a vital part of diversifying and growing our economy. As an island state, it makes clear sense to support these companies working in the ocean sciences field. Ocean sciences are an intrinsic and meaningful part of the State. Innovation as a result of research and development contributes greatly to our economic growth and is a catalyst for job creation and higher standards of living for our young people. I urge you to pass this bill.



Chamber of Commerce HAWAII
The Voice of Business

LATE

**Testimony to the Senate Committee on Energy, Economic Development,
and Tourism**

**Friday, February 7, 2020 at 2:50 P.M.
Conference Room 414, State Capitol**

RE: SB 3035 RELATING TO TAXATION

Chair Wakai, Vice Chair Taniguchi, and Members of the Committee:

The Chamber of Commerce Hawaii ("The Chamber") **supports** SB 3035, which establishes the ocean sciences research tax credit for businesses with the principal purpose of research and development in the field of ocean sciences.

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.

Hawaii's geographical location makes it an ideal place to conduct research in the area of ocean sciences and encourages the growth of research and development of businesses already operating in this field. As a result, we can help promote the creation of innovation and technology that will be beneficial in both enhancing Hawaii's economy and moving us toward a more sustainable future.

Thank you for the opportunity to testify.