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February 4, 2009

The Honorable Carol Fukunaga
Chair, Senate Committee on Economic Development & Technology
State Capitol, Room 216
Honolulu, Hawaii 96813

The Honorable Angus McKelvey
Chair, House Committee on Economic Revitalization, Business & Military Affairs
State Capitol, Room 427
Honolulu, Hawaii 96813

RE: The Correlation to the Department of Taxation Testimony and to Report Entitled "The Impact of the High Technology Business Investment Tax Credit on Hawaii's Economy for Calendar Year 2007" (December 2008)

Dear Chairs Fukunaga and McKelvey:

This letter responds to your letter dated January 27, 2009 regarding the correlation of the Department of Taxation testimony to the report entitled "The Impact of the High Technology Business Investment Tax Credit on Hawaii's Economy for Calendar Year 2007" (December 2008).

1. **Indicative Acquisition Cost per position:** The December 2008 report identifies "an indicative acquisition cost of approximately \$535,000."

a. *Please explain how this number was computed. Was the \$535,000 obtained by using \$1.2 billion invested in 333 QHTBs during 2000-2007 (December 2008 report, page 5) and dividing the investment number by 2,245 employee jobs reported by 177 QHTBs in 2007 alone?*

The \$535,000 was obtained by dividing the \$1.2 billion invested in 333 QHTBs during 2000-2007 by the 2,245 employees (full-time and part-time) employed by the QHTBs in Hawaii for the 52 consecutive weeks or 12 consecutive months during the weeks that included 12/12/07.

Prior to 2007, we did not ask the QHTBs to differentiate between jobs created in Hawaii to jobs created outside of Hawaii. Indeed, in our October 2007 report ("Report on the Operations of Qualified High Technology Businesses from 2002 through 2006"), we noted that in about 7% of the responses, the salaries paid exceeded the costs incurred in Hawaii, even though these costs include employee salaries (this is an indication that certain QHTBs might have included the out-of-State jobs in their responses). In addition, prior to 2007, no definition was provided for "job created" (some of the QHTBs measured jobs as full-time equivalent, whereas others did not). Finally, jobs created in one year may be lost in another; hence, jobs created figures prior to 2007 do not provide reliable information about the number of jobs now present in the QHTBs.

- b. *In your testimony, you stated that 2,118 independent contractor jobs that were paid a total of \$94 million (December 2008 report, page 10) were not included in the calculation of the acquisition costs per position. We believe that all types of jobs - whether full-time or part-time positions within individual Act 221 businesses, or independent contractors, consultants and others whose services contribute to the growth and expansion of Act 221 businesses should be counted. As such, if the contributions of these independent contractors were included in the calculation of the "indicative acquisition cost per position," what would the Department's cost estimate per position be?*

Because we do not know how many jobs the 2,118 independent contractors represent, *i.e.*: how many individuals and for how long the jobs created by QHTBs extended, we do not believe that we can include the independent contractor data.

- c. *Why was the \$1.2 billion used as the cost number to calculate job creation in the Department's report when the report also stated that the total estimated costs of the investment credit were \$657.5 million (December 2008 report, page 17)?*

Yes, as explained in "1.a." above.

- d. *Please state whether the Department divided eight years of costs (2000-2007) by the number of permanent or part-time employee jobs reported by the 177 Act 221 filers in 2007. If that is true, then please provide a calculation reflecting the 2007 costs and 2007 job creation reported by 177 Act 221 filers for the single year to offer an apples-to-apples comparison.*

If the investment amount received by the 177 QHTBs is divided by the number of full-time and part-time jobs employed by the QHTBs in Hawaii for the 52 consecutive weeks or 12 consecutive months during the weeks that included 12/12/07, the figure would be \$136,808 (\$307.1 million divided by 2,245). However, there is no empirical data to substantiate that the 2,245 jobs were linked to only the investment that occurred for tax year 2007. In fact it can be argued

that companies used prior year investments to reach a plateau that allowed them to hire and retain the equivalent of 2,245 full time positions. Thus there is validity in using the data provided in the report which contained a cost figure of \$535,000. Unless the Legislature enacts statutory changes to Act 221 that would require companies to report the exact number of new positions they created in each of the prior fiscal years for which they received a tax credit supported investment, this per job costs can only be approximated using the information currently available.

If total costs for Act 221 filers (2000-2007) cannot be compared against the total number of permanent or part-time employees, independent contractors and consultants employed by all Act 221 companies filing between 2000-2007, please identify the type of information needed from Act 221 filers who did not file a return in 2007 (e.g. based on new Act 221 investments).

Please see below the Department's suggested changes to Act 206, SLH 2007 (HB 1631 HD2, SD2, CD1).

- e. *In adopting Act 206, SLH 2006, the Legislature was mindful of the fact that tech start-ups are rarely profitable, nor do they employ large numbers of staff, during their early years when venture financing is necessary.*

As such, the type of data that is valuable to the Legislature in evaluating the costs and benefits of Act 221 is a comparison of total investments made by Hawaii and out-of-state investors, against total expenditures made by Act 221 businesses in Hawaii. Such a comparison would be similar to the type of comparisons made when comparing expenditures for construction (e.g. large-scale public works, public facilities, etc.) against the numbers of seasonal jobs and expenditures made within the local economy.

What additional information can Department of Taxation provide to reflect the comparison of total investments made by Hawaii/non-Hawaii investors in the 177 Act 221 filers, against the numbers of jobs and expenditures made within the local economy for 2007?

In order to determine whether the investors are Hawaii resident or non-Hawaii resident, we will need to research the address stated in the taxpayers' income tax return, and make an assumption that if the address is in Hawaii, the taxpayers are Hawaii resident; otherwise, they will be considered non-Hawaii residents. However, the non-Hawaii investors who do not have Hawaii tax liability may allocate their tax credits to Hawaii investors for equity; hence, most likely, they need not file Hawaii income tax return to claim the credit. If non-Hawaii investors do not file their income tax credit to claim the credit, we will not have their information.

An alternative is to research the certification data and make an assumption that for investors with the ratio of total credit to total cash investment of more than 1:1, non-Hawaii investors are involved.

Both methodologies mentioned above would require extensive research.

2. **"Indicative Acquisition Cost for each successful QHTB":** December 2008 report, page 17.

- a. *The Department's December 2008 report concludes, "the indicative State acquisition cost for each successful QHTB who received funds between July 1, 2007 and December 31, 2007 is \$31.6 million." Please provide and explanation of how the \$31.6 million was computed, and the assumptions that were used in arriving at the final calculation.*

The \$31.6 million was derived by dividing the \$1.2 billion by 38 (number of QHTBs that have worldwide revenue greater than or equal to worldwide expenses).

- b. *Was the \$31.6 million figure obtain by dividing the \$1.2 billion invested in 333 Act 221 filers between 2000-2007 (December 2008 report, page 5) by 38 Act 221 filers who received investments between July 1, 2007-December 31, 2007 while they were already profitable (December 2008 report, page 17)?*

Regarding the 38 QHTBs referred in the report: Some of them received investments prior to July 1, 2007 and continued to receive investments after July 1, 2007. Some of them received investments prior to July 1, 2007 and did not receive investments after July 1, 2007.

- c. *What is the Department's rationale for limiting the definition of "successful QHTBs" only to those QHTBs that were profitable and who also received investments during the period July 1, 2007 through December 31, 2007, while attributing to those QHTBs a cost estimate equal to all investments made by 33 QHTBs over an 8-year period?*

Profitability is generally the main factor in measuring whether a company is successful by financial measurement standards. As stated above, the 38 QHTBs do not only represent those that received investments during the July 1, 2007 through December 31, 2007. The figure includes QHTBs that received investments prior to July 1, 2007.

In addition, as a measure of success, the Department also listed the number of patents, copyrights, trade secrets, licenses, and trademarks that the 177 companies owned.

- d. *What is the Department's rationale for identifying only profitable QHTBs as being "successful" when most tech companies need investment capital precisely because they are not profitable during their start-up phases (e.g. often because of the high costs of research)? Recent research states that venture-backed companies who successfully achieved a public offering in 2008 required an average of 8.3 years to achieve that level of profitability.*

Act 221 and its predecessor Acts have been operating since 1999. This means that almost 10 years have elapsed to determine to what extent the firms that have used the tax credits offered under these Acts are operating in a manner that allows them to migrate off of Act 221. The Legislature correctly recognized that this law should not continue indefinitely. At some point companies should be able to migrate to Phase II funding or be of a nature that private capital is willing to invest and risk their money in these firms. Profitability is a measure of private capital attraction. We believed the Legislature would want to know this fundamental information.

3. *Excluded data from September 2008 report: Additional information on the benefits of Act 221 published in the September 2008 report (e.g. \$1.4 billion spent in Hawaii by QHTBs between 2002-2007) was not included in the December 2008 report. What was the basis for excluding this information from the December 2008 report? Please identify and list any other Act 221 information from the September 2008 report that was not included in the December 2008 report, and provide the rationale for the exclusion.*

The purpose of the two reports is different as specified by Act 206. The September 2008 report was a compilation of the data provided by the reporting firms to the Department of Taxation as permitted via the list of data points specified in the N-317 form. The December 2008 report was an analysis, not a compilation, of those data points that help identify whether the Act is achieving its original intent. The Legislature correctly recognized the need for two different reports. The Department responded in keeping with the Legislature's desire.

4. *Number of QHTBs Reporting (Partial) Benefits on Form N-317: 333 vs. 177: Between 2002-2007, 333 QHTBs filed Form N-317, while 177 QHTBs filed Form N-317 in 2007 alone. Pursuant to Act 206, SLH 2006, Form N-317, was significantly enhanced in 2007 to ask more questions to measure the benefits of the Act 221 investment credit.*

Act 206 statutorily required QHTBs who received new investments on or ~~before~~ after July 1, 2007 to file the enhanced Form N-317 (although some additional QHTBs voluntarily filed Form N-317 in 2007. Prior to 2007, the Department required QHTBs to file Form N-317 only in the year that they received new investment (and not over the entire 5 year period).

Prior to Act 206, SLH 2007, there was no specific statutory penalty for not filing Form N-317. The Department's position has always been that the QHTBs are required to file

Form N-317 over the entire 5 year period. The former Form N-317 prior to Act 206, SLH 2007, did not include the detail present in the current Form N-317.

However, since Act 206, SLH 2006 sought to compile data regarding all Act 221 investments, costs, and benefits, the data being analyzed for 2007 results in an under-reporting of the benefits of Act 221, while the full costs of the tax credit have been reported on separate Form N-318. Please provide recommendations for amendments to Act 206, SLH 2006 that would require all Act 221 filers (from 2002-present) to file an N-317 form each year irrespective of whether new Act 221 investments were received. The proposed change will allow Department of Taxation to collect accurate information from filers of N-317 and N-318 forms.

To accomplish what you desire, the Department would like to suggest the following changes to Act 206, SLH 2007 (HB 1631 HD2, SD2, CD1):

SECTION 2. (a) A qualified high technology business that accepts or has accepted an investment for which the credit under section 235-110.9, Hawaii Revised Statutes, may be claimed shall complete and file with the director of taxation through the department website, an annual survey on electronic forms prepared and prescribed by the department. The annual survey shall be filed before June 30 of each calendar year [~~following the five calendar years in which the credit for the investment may be claimed under section 235-110.9, Hawaii Revised Statutes~~]. The department may adjust the due date of the annual survey by rule without regard to Chapter 91.

...
(c) A qualified high technology business required to file an annual survey under subsection (a) that fails to file the survey by the due date or any extension thereof, shall be assessed a penalty of \$1,000 per month for each month the annual survey is not filed [~~not to exceed a total of \$6,000 for every annual survey not filed~~]. Penalties collected under this subsection shall be deposited into the tax administration special fund established under section 235-20.5, Hawaii Revised Statutes.

...
SECTION 8. This Act shall take effect on July 1, 2007, [~~and~~] except Section 4 shall apply to investments received by a qualified high technology business that received investments after June 30, 2007; provided that this Act shall be repealed on January 1, 2011, and sections 235-20.5 and 235-110.9(b), Hawaii Revised Statutes, shall be reenacted in the form in which they read on the day before the effective date of this Act.

It should be kept in mind that the Department will never be able to obtain reporting from all QHTBs who received investments prior to July 1, 2007 since some of these QHTBs may have ceased to exist. Also it should be noted that the QHTBs that did not file 2007 Form N-317 may only represent about 8% of total investments received by QHTBs through 2007.

In addition, please find below Table 1 showing a breakdown of the amount of investment received by the 177 QHTBs in 2007. This information is essential for your consideration of HB 1157/SB 975 (relating to high technology business investment tax credit). As shown in Table 1, 155 QHTBs received less than \$3 million in cash investments in 2007, whereas only 4 QHTBs received \$10 million or more in cash investments in 2007. Limiting the investment amount to \$10 million will only impact 4 or less QHTBs (less than 2.3%). Most of the QHTBs (more than 97.7%) will not be impacted.

Table 1. Breakdown of the Amount of Investment Received by the 177 QHTBs in 2007

Category of Investment Received	# of QHTBs	Total Investment (\$)	Hawaii Revenue (\$)	Hawaii Expenses (\$)	Hawaii Payroll Expenses (\$)
>= \$ 10,000,000	4	166,056,728	23,616,188	112,327,964	8,292,568
\$5,000,000 - < \$10,000,000	6	41,774,198	4,103,824	26,216,072	6,725,395
\$3,000,000 - < \$5,000,000	12	45,998,693	5,553,047	39,836,011	12,050,117
< \$3,000,000	155	53,304,609	172,571,921	206,163,150	99,933,943
TOTAL	177	307,134,228	205,844,980	384,543,197	127,002,023

Category of Investment Received	# of QHTBs	Total Investment (\$)	Hawaii Independent Contractor (Scientific & Technical) (\$)	Hawaii Independent Contractor (Performing Arts) (\$)	Hawaii Independent Contractor (Other) (\$)
>= \$ 10,000,000	4	166,056,728	233,014	51,338,423	329,401
\$5,000,000 - < \$10,000,000	6	41,774,198	56,060	2,162,863	9,086,425
\$3,000,000 - < \$5,000,000	12	45,998,693	742,353	169,536	6,550,377
< \$3,000,000	155	53,304,609	13,838,244	1,556,335	7,925,295
TOTAL	177	307,134,228	14,869,671	55,227,157	23,891,498

Category of Investment Received	# of QHTBs	Total Investment (\$)	2007 Full-time Employees	2007 Part-time Employees	2007 Temporary Workers	2007 Independent Contractors
>= \$ 10,000,000	4	166,056,728	137	10	7	922
\$5,000,000 - < \$10,000,000	6	41,774,198	27	1	399	121
\$3,000,000 - < \$5,000,000	12	45,998,693	155	14	12	137
< \$3,000,000	155	53,304,609	1,131	129	223	938
TOTAL	177	307,134,228	1,450	154	641	2,118

Category of Investment Received	# of QHTBs	Total Investment (\$)	2007 Research & Development Credit (HRS 235-110.91) (\$)
>= \$ 10,000,000	4	166,056,728	246,555
\$5,000,000 - < \$10,000,000	6	41,774,198	1,212,806
\$3,000,000 - < \$5,000,000	12	45,998,693	1,791,838
< \$3,000,000	155	53,304,609	11,598,320
TOTAL	177	307,134,228	14,849,519

If you have any questions regarding these comments, please feel free to contact me directly at 587-1513 or on my cell at 620-5393.

Very truly yours,



KURT KAWAFUCHI
 Director of Taxation