

DAVID Y. IGE
GOVERNOR

SHAN TSUTSUI
LT. GOVERNOR



STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1540
FAX NO: (808) 587-1560

MARIA E. ZIELINSKI
DIRECTOR OF TAXATION

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

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

Date: Tuesday, February 28, 2017

Time: 1:00 P.M.

Place: Conference Room 308, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.B. 593, H.D. 1, Relating to Research Activities

The Department of Taxation (Department) has serious concerns regarding this H.B. 593, H.D. 1, due to its non-conformity to the Internal Revenue Code (IRC), and provides the following comments for your consideration.

H.B. 593, H.D. 1, amends the Tax Credit for Research Activities (TCRA) under section 235-110.91, Hawaii Revised Statutes, such that the credit is calculated based on all qualified research expenses for the taxable year, rather than the incremental increases, and appropriates funds for a compliance specialist position within the Department. The House Committee on Economic Development and Business defected the effective date to July 1, 2038.

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 Department strongly believes that taken together, the federal and the State TCRAs provide substantial incentives for such innovation, even for new start-up companies. For example, the ASC method allows taxpayers to claim research credits even if research costs remain the same or when costs may 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 have declined from the previous year.

The State TCRA is a refundable credit, making it far more generous than the federal TCRA, which is a non-refundable credit. The refundable aspect of the State TCRA makes it far more enticing for taxpayers to stretch the credit by including non-eligible expenses, making it especially vulnerable to wrongful claims and abuse.

The Department notes that in most cases, it prefers conformity to the IRC where possible, as this provides clear guidance to both the Department and to taxpayers. There is substantial guidance issued in the form of rules and regulations issued by the Internal Revenue Service (IRS), as well as court decisions interpreting IRC section 41, which establishes the federal credit. This measure decouples the TCRA from the federal TCRA and adds an extraordinary amount of undue complexity which will require an inordinate amount of time and resources to evaluate a taxpayer's claim of the credit.

The TCRA is highly technical and the most complex tax credit, and the Department relies on the expertise of the IRS in determining whether a TCRA claim is justified. Past experience has shown that with respect to this credit, taxpayers have taken unreasonable positions with the Department due to its limited resources. 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.

Validation of tax credit claims requires review of extremely detailed and technical information, and disputes concerning the credit are not easily resolved. It is not uncommon, for example, that audits and the related appeals regarding the federal TCRA involves extensive and costly litigation that often take more than ten years for complete resolution. Given that the Department does not have the personnel, resources and expertise to insure that claims for the credit are valid, effective administration and enforcement of this credit is very difficult for the Department.

While the Department appreciates the provision for one additional person to assist in analyzing credit claims, due to the complexity of these types of audits and the types of expertise necessary to review such claims, it is far more efficient if the state TCRA conformed to the federal TCRA. Furthermore, the Department notes that the appropriation provided in Section 2 is for only two fiscal years and this tax credit has no sunset date.

If the Committee wishes to advance this measure without regard to the benefits of conformity to the IRC, the Department suggests making the credit nonrefundable. In the alternative, if the intent of this measure is provide taxpayers with money to do research, then a grant program seems far more efficient. The tax system cannot be controlled with precision like a grant program can.

Finally, it should be noted that the Consolidated Appropriations Act, 2016 (Pub. L. 114-113) retroactively reinstated the research credit for qualified research expenses (QREs) paid or incurred in 2015, and made the credit permanent. Accordingly, the Department recommends that the measure be rewritten, as follows:

Section 41 (with respect to the credit for increasing research activities) and section 280C(c) (with respect to certain expenses for which the credit for increasing research activities are allowable) of the Internal Revenue

~~Code shall be operative for the purposes of this chapter as provided in this section; provided 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; provided further that the federal tax provisions in section 41 of the Internal Revenue Code, as that section was enacted on December 31, 2011, irrespective of any subsequent changes to section 41 of the Internal Revenue Code, shall remain in effect for purposes of determining the state income tax credit under this section; provided further that the federal tax provisions in section 41 of the Internal Revenue Code, as enacted on December 31, 2011, irrespective of any subsequent amendments to section 41 of the Internal Revenue Code, shall apply only to expenses incurred for qualified research activities after December 31, 2012.~~

Thank you for the opportunity to provide comments.



Written Statement of
Robbie Melton
Executive Director & CEO
High Technology Development Corporation
before the
House Committee on Finance
Tuesday, February 28, 2017
1:00 p.m.
State Capitol, Conference Room 308

In consideration of
HB593 HD1
RELATING TO RESEARCH ACTIVITIES.

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

The High Technology Development Corporation (HTDC) **supports** HB593 HD1 that provides that, notwithstanding provisions of the Internal Revenue Code to the contrary, the amount of the state tax credit for research activities shall be calculated based on all qualified research expenses for the taxable year and appropriates funds for a compliance specialist position within DOTAX to assist with administration of the tax credit.

As part of HTDC's vision to create 80,000 new innovation jobs in Hawaii earning \$80,000 or more by 2030, HTDC supports initiatives aimed at promoting technology and innovation jobs.

In 2015, 12 companies completed the required R&D tax credit survey and reported claiming \$1.1 million. The companies reported over 76% of the 270 full time employees earned over \$60,000 and 41% earned over \$100,000. 70% of the revenue generated from these companies came from out of state and 32% was from intellectual property. 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.

We respectfully request correction of the defective effective date. We support this initiative as long as it does not replace our priorities requested in the Executive Budget.

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: HB 593, HD-1

INTRODUCED BY: House Committee on Economic Development & Business

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.”

Appropriates \$_____ for one full-time equivalent position in the department of taxation to assist with the certification and administration requirements.

EFFECTIVE DATE: July 1, 2038; applicable to tax years beginning after December 31, 2016.

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 2/25/2017



Chamber of Commerce HAWAII

The Voice of Business

**Testimony to the House Committee on Finance
Tuesday, February 28, 2017 at 1:00 P.M.
Conference Room 308, State Capitol**

RE: HOUSE BILL 593 HD1 RELATING TO RESEARCH ACTIVITIES

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

The Chamber of Commerce Hawaii ("The Chamber") **supports** HB 593 HD1, which provides that, notwithstanding provisions of the Internal Revenue Code to the contrary, the amount of the state tax credit for research activities shall be calculated based on all qualified research expenses for the taxable year; appropriates funds for a compliance specialist position within DOTAX to assist with administration of the tax credit.

The Chamber is Hawaii's leading statewide business advocacy organization, representing about 1,600+ 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.

This bill provides crucial support to research and development companies within the state. The credit would provide more incentive for research and development companies to expend their resources within the state of Hawaii. This bill would boost the state's economy and provide further support to the development of Hawaii's innovation industry.

Thank you for the opportunity to testify.

From: mailinglist@capitol.hawaii.gov
Sent: Sunday, February 26, 2017 3:19 AM
To: FINTestimony
Cc: chung@navatekltd.com
Subject: Submitted testimony for HB593 on Feb 28, 2017 13:00PM

HB593

Submitted on: 2/26/2017

Testimony for FIN on Feb 28, 2017 13:00PM in Conference Room 308

Submitted By	Organization	Testifier Position	Present at Hearing
ann chung	Navatek	Support	Yes

Comments: We strongly support HB593. The original bill was passed in 2014 to support research and development in Hawaii. HB593 simply amends one sentence in the bill to de-couple the credit from the federal base requirement. The existing law currently only allows for the credit on the incremental increase in qualified research expenses from the previous year – significantly reducing the amount of credit local Hawaii companies can qualify for. Supporting this amendment 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.

Please note that testimony submitted less than 24 hours prior to the hearing, improperly identified, or directed to the incorrect office, may not be posted online or distributed to the committee prior to the convening of the public hearing.

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

Before the
COMMITTEE ON FINANCE

February 28, 2017
1:00 p.m.
State Capitol, Conference Room 308
In Support of

HB593 RELATING TO RESEARCH ACTIVITIES

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

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

Re: Testimony in Support of HB593

Honorable Chair, Vice-Chair and Committee Members:

Thank you for the opportunity to submit testimony **in support of HB593**

Oceanit currently employs about 100 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.

We urge you to support HB593.