



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

ON THE FOLLOWING MEASURE:

S.B. NO. 3035, S.D. 1, RELATING TO TAXATION.

BEFORE THE:

SENATE COMMITTEE ON WAYS AND MEANS

DATE: Thursday, February 20, 2020 **TIME:** 10:35 a.m.

LOCATION: State Capitol, Room 211

TESTIFIER(S): WRITTEN TESTIMONY ONLY
(For more information, contact Cynthia M. Johiro, Deputy Attorney General, at 586-1470)

Chair Dela Cruz 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. No. 3035, S.D. 1, is to “establish an ocean science research tax credit to foster research and development to expand and diversify Hawaii’s economy.” See S.B. No. 3035, S.D. 1, 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, 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 6-10. (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; small businesses located outside the State will not be able to claim the tax credit. Thus, it could be argued that the bill discriminates against interstate commerce by benefitting in-state interests and burdening out-of-state interests.

Based on the foregoing, we respectfully ask that this concern be addressed to avoid a challenge under the Commerce Clause of the United States Constitution. One way to do so is to remove the phrase "in the State" 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. Thank you for the opportunity to express our concern.



NATURAL ENERGY LABORATORY OF HAWAII AUTHORITY

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

Written Only

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

SENATE COMMITTEE ON WAYS AND MEANS

Thursday, February 20, 2020
10:35 am
State Capitol, Conference Room 211

in consideration of
S.B. 3035 S.D. 1
RELATING TO TAXATION.

The Natural Energy Laboratory of Hawaii Authority (NELHA) supports the intent and is pleased to comment on S.B. 3035 S.D. 1 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

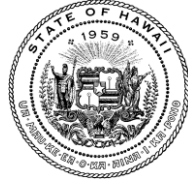
ocean science. This accelerator has been very successful and recently completed its first cohort of 13 companies. We are in discussions regarding new leases at HOST Park with two of the companies from the HATCH accelerator and one company in a similar field which just completed the Elemental Accelerator. 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.

DAVID Y. IGE
GOVERNOR

JOSH GREEN M.D.
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

RONA M. SUZUKI
DIRECTOR OF TAXATION

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

To: The Honorable Donovan M. Dela Cruz, Chair;
The Honorable Gilbert S.C. Keith-Agaran, Vice Chair;
and Members of the Senate Committee on Ways and Means

From: Rona M. Suzuki, Director
Department of Taxation

Re: **S.B. 3035, S.D. 1, Relating to Taxation**

Date: Thursday, February 20, 2020

Time: 10:35 A.M.

Place: Conference Room 211, State Capitol

The Department of Taxation (Department) provides the following comments regarding S.B. 3035, S.D. 1.

S.B. 3035, S.D. 1, establishes the ocean sciences research tax credit up to an unspecified amount. The Senate Committee on Energy, Economic Development, and Tourism adopted the Department's suggestion to provide that no other credit may be claimed based on costs that were paid using investment monies for which a credit was claimed under this section. The measure is effective upon approval and applies to taxable years beginning after December 31, 2020, 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, this measure 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 also appreciates that a definition of "small business" was added to S.D. 1, but notes that the term needs to be further clarified. "Small business" is defined as a business that employs ten or less employees and has revenues of less than \$1,000,000 per year. Any entity could qualify under this definition by creating a subsidiary. In addition, if the intent is to limit the **gross** income of the entity then this should be explicitly stated. To remedy these issues, the Department suggests amending the definition of "small business" to read:

"Small business" means a business that employs ten or less employees and has gross revenues of less than \$1,000,000 a year. For the purpose of this section, all related entities within the meaning of section 168(h)(4) of the Internal Revenue Code shall be treated as a single entity.

Finally, the Department notes that the definition of "qualified entity" that requires that the taxpayer be a small business "in the State" 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.

Thank you for the opportunity to provide comments.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Establish Ocean Sciences Research Tax Credit

BILL NUMBER: SB 3035, SD-1

INTRODUCED BY: Senate Committee on Energy, Economic Development, and Tourism

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 are 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.

Provides that no other credit under this chapter shall be claimed for expenses or costs paid with an investment made into a qualified entity for which this credit was claimed.

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.

Defines “small business” as a business that employs ten or less employees and has revenues of less than \$1,000,000 a year.

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 2/17/2020



Statement of
Hermann Kugeler
Business Development Manager
Makai Ocean Engineering, Inc.
before the
Senate Committee on Ways and Means
Wednesday, February 20, 2020
10:35am
State Capitol, Conference Room 211
In consideration of
SB3035
RELATING TO TAXATION.

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

Makai Ocean Engineering, Inc. **SUPPORTS SB3035, WITH AMENDMENT** that establishes the ocean sciences research tax credit. We respectfully request the following amended language:

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF HAWAII:

SECTION 1. The legislature finds that to keep our community vibrant and our economy expanding, Hawaii needs to focus on innovation sectors that will bring new dollars and high-demand jobs to Hawaii's economy. As an island state, research and development in ocean sciences is an intrinsic and essential part of our future sustainability. Supporting and encouraging more research and development in ocean and marine sciences will foster and fuel innovative ideas and promote entrepreneurship that will better position Hawaii for future economic growth and expansion. Innovation resulting from research and development contributes greatly to economic growth; it is often the catalyst for change, job creation, and a higher standard of living. Expanding Hawaii's research and development industry in ocean sciences will bring in new dollars to our

State's economy and create a wide range of high-skilled, high-paying jobs for our young people so they may continue to live and work in Hawaii. Research and development in ocean sciences may be vital to Hawaii's future economic growth.

The purpose of this Act is to establish an ocean sciences research tax credit to foster research and development to expand and diversify Hawaii's economy.

SECTION 2. Chapter 235, Hawaii Revised Statutes, is amended by adding a new section to be appropriately designated and to read as follows:

"§235- Ocean sciences research; tax credit. (a) There shall be allowed to each taxpayer subject to the taxes imposed by this chapter an ocean sciences research tax credit that shall be deductible from the taxpayer's net income liability, if any, imposed by this chapter.

(b) The amount of the tax credit shall be equal to _____ per cent of the investment made into the qualified entity ~~for research and development in the field of ocean sciences~~; provided that:

(1) The ~~qualified entity, including all partners and members of the qualified entity taxpayer~~ shall not claim any credit in any one taxable year that exceeds \$ _____; provided that if the total amount of credits applied for in any particular year exceeds the aggregate amount of credits allowed for such year under this section the excess shall be treated as having been applied for in the subsequent year and shall be claimed in such year; provided further that no excess shall be allowed to be claimed after December 31, 2025; and

(2) In no event shall a ~~qualified entity or any other~~ taxpayer claim a credit under this section after December 31, 2025.

(c) The credit allowed under this section shall be claimed against the net income tax liability for the taxable year. If the tax credit under this section exceeds the taxpayer's income tax liability, the excess of the tax credit over liability may be used as a credit against the taxpayer's net income tax liability in subsequent years until exhausted. All claims, including amended claims, for a tax credit under this section 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 to comply with the foregoing provision shall constitute a waiver of the right to claim the credit.

(d) The director of taxation shall prepare any forms that may be necessary to claim a credit under this section. The director may also require the taxpayer to furnish information to ascertain the validity of the claim for credit made under this section. The director of taxation may adopt rules pursuant to chapter 91 to effectuate the purposes of this section.

(e) Any taxpayer claiming a tax credit under this section, within ninety days of the end of the calendar year in which the credit is properly claimable, shall submit the following information to the department of taxation:

(1) The amount of the eligible costs for which the tax credit may be claimed; and

(2) The qualified entity that incurred the costs.

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.

(f) 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.

(g) This section shall not apply to taxable years beginning after December 31, 2025.

(h) For the purposes of this section:

"Net income tax liability" means income tax liability reduced by all other credits allowed under this section.

"Qualified entity" means a small business in the State, 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.

"Small business" means a business that employs ~~ten~~ fifty or less employees ~~and has revenues of less than \$1,000,000 a year.~~

SECTION 3. New statutory material is underscored.

SECTION 4. This Act, upon its approval, shall apply to taxable years beginning after December 31, 2020.



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 **SUPPORT SB3035** with the amendment included above, 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.