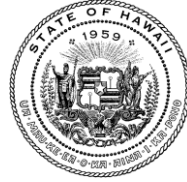


DAVID Y. IGE
GOVERNOR

JOSH GREEN M.D.
LT. GOVERNOR



STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
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RONA M. SUZUKI
DIRECTOR OF TAXATION

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

To: The Honorable Ryan I. Yamane, Chair;
The Honorable Chris Todd, Vice Chair;
and Members of the House Committee on Water, Land, & Hawaiian Affairs

From: Rona M. Suzuki, Director
Department of Taxation

Re: **S.B. 3035 S.D. 2, Relating to Taxation**

Date: Wednesday, March 11, 2020

Time: 9:00 A.M.

Place: Conference Room 325, State Capitol

The Department of Taxation (Department) appreciates the intent of this measure, but **has concerns about S.B. 3035, S.D. 2, as drafted.**

This measure establishes the ocean sciences research tax credit for investments made into a small business located in the State engaged in the field of ocean sciences. The credit is equal to an unspecified percentage of the investment and subject to an overall cap. The measure has a defective effective date of July 1, 2050, but would otherwise apply 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 and where the research was performed. This is very similar to the high technology business investment tax credit (QHTB credit) codified at section 235-110.9, Hawaii Revised Statutes (HRS), which also provided a tax credit based on investment rather than the actual activity that the State intended to incentivize. The Department also notes that the credit only requires that the business be involved in NAICS code 541715 research at the time that the investment was made. There is no requirement that the business continue in that field and no recapture provisions if the business fails to conduct any qualified activities. The Department suggests resolving these issues.

In addition, **unlike the QHTB credit, this measure does not require the investment to actually be at-risk.** The Department strongly recommends 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.

“Small business” is defined as a business that employs fifty or less employees and has revenues of less than \$5,000,000 a year. A business could simply create a subsidiary to skirt the stated requirements. To prevent this, the Department suggests **amending the definition of “small business” such that all related entities are combined in determining whether the limits have**

been exceeded as follows:

"Small business" means a business that employs fifty or less employees and has revenues of less than \$5,000,000 a year. For the purposes of this section, all related entities as set forth in section 168(h)(4) of the Internal Revenue Code shall be treated as a single entity.

The Department further notes that **a research credit is already available under section 235-110.91, HRS**. Instead of enacting a new credit, the Department suggests amending the existing research credit if necessary. A new credit incentivizing the same activity is not efficient in terms of tax policy and administration.

Finally, the Department **defers to the Attorney General regarding the Constitutionality** of the requirement that the business be physically present in Hawaii for at least five years

Thank you for the opportunity to provide comments.



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

ON THE FOLLOWING MEASURE:

S.B. NO. 3035, S.D. 2, RELATING TO TAXATION.

BEFORE THE:

HOUSE COMMITTEE ON WATER, LAND, & HAWAIIAN AFFAIRS

DATE: Wednesday, March 11, 2020 **TIME:** 9:00 a.m.

LOCATION: State Capitol, Room 325

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

Chair Yamane 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. 2, 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. 2, 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 10-14. (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 meet the criteria can 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

HOUSE COMMITTEE ON WATER, LAND & HAWAIIAN AFFAIRS

Wednesday, March 11, 2020
9:00 am
State Capitol, Conference Room 325

in consideration of
S.B. 3035 S.D. 2
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. 2 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.



Statement of
Hermann Kugeler
Business Development Manager
Makai Ocean Engineering, Inc.
before the
House Committee on Water, Land, & Hawaiian Affairs
Wednesday, March 11, 2020
9:00am
State Capitol, Conference Room 325
In consideration of
SB3035
RELATING TO TAXATION.

Chair Yamane, Vice Chair Todd, 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 and 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, which may allow them to 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:

"5235- Ocean sciences research investment tax credit.

(a) There shall be allowed to each taxpayer subject to the taxes imposed by this chapter an ocean sciences research investment 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 further that if the

total amount of credits applied for in any particular year exceeds the aggregate amount of credits allowed for that year, under this section, the excess shall be treated as having been applied for in the subsequent year and shall be claimed in the subsequent year; ~~and 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:

(1) Shall prepare any forms that may be necessary to claim a credit under this section;

(2) May require the taxpayer to furnish information to ascertain the Validity of the claim for credit made under this section; and

(3) 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 North American Industry Classification System code 541715. "Small business" means a business that employs fifty or less employees ~~and has revenues of less than \$5,000,000 per year.~~

SECTION 3. New statutory material is underscored.

SECTION 4. This Act shall take effect on July 1, 2050, and shall apply to taxable years beginning after December 31, ~~2019~~ 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.

SB-3035-SD-2

Submitted on: 3/9/2020 9:33:55 AM

Testimony for WLH on 3/11/2020 9:00:00 AM

Submitted By	Organization	Testifier Position	Present at Hearing
Dwamato	Individual	Support	No

Comments:



Chamber of Commerce HAWAII

The Voice of Business

**Testimony to the House Committee on Water, Land, and Hawaiian Affairs
Wednesday, March 11, 2020 at 9:00 A.M.
Conference Room 325, State Capitol**

RE: SB 3035 SD2, RELATING TO TAXATION

LATE

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

The Chamber of Commerce Hawaii ("The Chamber") **supports** SB 3035 SD2, which establishes the ocean sciences research tax credit and applies to taxable years beginning after December 31, 2020.

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.