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HOUSE COMMITTEE ON ECONOMIC REVITALIZATION, BUSINESS & MILITARY
AFFAIRS
TESTIMONY REGARDING SB 2290 SD 2
RELATING TO ECONOMIC DEVELOPMENT

WRITTEN TESTIMONY ONLY

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: MARCH 11, 2010
TIME: 8:30AM
ROOM: 312

This measure, among other things, amends the current law relating to the State private investment fund, which allows transferability of tax credits. This measure also extends the credits to include insurance premiums taxes.

The Department of Taxation ("Department") **opposes any revenue loss** anticipated by this measure and requests amendments to **disallow transferability of credits as a matter of policy.**

I. THE DEPARTMENT OPPOSES ALLOWING TRANSFER OF CREDITS.

The Department is strongly opposed to any provision that allows Hawaii tax credits to be sold, assigned, or transferred. Allowing taxpayers to market or sell their tax credits is fundamentally poor tax policy. Selling tax credits can be subject to abuse and suspect motivation by parties involved.

The Department's fundamental and primary concerns regarding credit transfers are the following:

- The transferability rewards a separate taxpayer unrelated to the taxpayer that generated the credit, which is fundamentally poor tax policy for encouraging behavior and directly rewarding that behavior;
- The Department is not setup to regulate credit transfers. Will the Department be required to establish a "Bureau of Credit Conveyances" in order to track transfers? If this is the case, resources will have to be dedicated to this;

- And, abuse relating tax credit transfer prices will be problematic. The State will be out a \$1 when taxpayers will be transferring this \$1 for pennies.

The Department suggests amending the bill to disallow transfers from taxpayers-to-taxpayers, and rather allow for a refundable credit if the credits are exercised. A refundable credit allows taxpayers that conducted the activity that generated the credit to receive a refund if the credit is in excess of tax liability.

Suggested language to eliminate transferring of credits amongst taxpayers is as follows:

SECTION 6. Section 211G-12, Hawaii Revised Statutes, is amended to read as follows:

"~~[+]§211G-12[+]~~ **Tax credits.** (a) The State shall issue tax credits to the corporation that may be transferred or otherwise used to reduce the tax liability of any taxpayer pursuant to chapter 235 or 241~~[-]~~, or section 431:7-202. The total amount of tax credits that may be issued, and which may be transferred pursuant to this chapter by the corporation is ~~[\$36,000,000-]~~ \$ _____.

~~(b)~~ Upon compliance with subsection ~~[(b)-]~~ (c), the tax credits issued to the corporation shall be freely transferable by the corporation to transferees ~~[and by transferees to subsequent transferees];~~ ~~[however,-]~~ provided that the tax credits ~~[se]~~ transferred by the corporation shall not be exercisable before July 1, ~~[2005,-]~~ _____, nor after July 1, ~~[2030,-]~~ _____. ~~[The corporation shall not transfer tax credits except in conjunction with a legitimate call on a corporation guarantee.]~~ The corporation shall immediately notify the president of the senate, the speaker of the house of representatives, and the governor in writing if any tax credit is transferred by the corporation ~~[in conjunction with a legitimate call on a corporation guarantee];~~ **provided that the corporation shall not be required to make that notification for transfers to subsequent transferees**.

~~[(b)-]~~ Subject to the annual authorization by the legislature, the corporation may transfer tax credits under this section up to the annual amount allowed under subsection (c). ~~Legislative authorization for the tax credits shall be by a separate legislative act.]~~

(c) The corporation shall determine the amount of individual tax credits to be transferred pursuant to this chapter ~~[and may negotiate for the sale of those credits]~~ subject only to the limits imposed by this chapter. The corporation shall limit the transfer of tax credits that may be claimed and used to reduce the tax otherwise imposed by chapter 235 or 241 or section 431:7-202 for one fiscal year ~~[(including any tax credits that are carried over by a taxpayer from a prior fiscal year and used~~

~~to reduce taxes otherwise imposed in the current fiscal year, as permitted in subsection (g)] to not more than an aggregate total of [\$12,000,000] \$_____ per fiscal year. The board shall clearly indicate on the face of the certificate or other document transferring the tax credit the principal amount of the tax credit and the taxable year or years for which the credit may be claimed.~~

(d) The corporation, in conjunction with the department of taxation, shall develop a system for registration of any tax credits issued ~~[or transferred]~~ pursuant to this chapter ~~[and a system of certificates that permits verification that any tax credit claimed upon a tax return is validly issued, properly taken in the year of claim, and that any transfers of the tax credit are made in accordance with this chapter].~~

(e) The corporation may pay a fee and provide other consideration in connection with the purchase by the corporation of a put option or other agreement pursuant to which a transfer of tax credits authorized by this chapter may be made.

(f) The tax credits issued ~~[or transferred]~~ pursuant to this chapter, upon election by the taxpayer at time of use, shall be treated as a payment or prepayment in lieu of taxes imposed under chapter 235 or 241[-], or section 431:7-202. Tax credits used pursuant to this chapter shall be claimed as a payment of tax or estimated tax for the purposes of chapter 235 or 241.

~~[(g) If the tax credits under this section exceed the taxpayer's income tax liability under chapter 235 or 241 for any taxable year, or for any other reason is not claimed by a taxpayer in whole or in part in any taxable year, the excess of the tax credit over liability, or the amount of the unclaimed tax credit, as the case may be, may be carried over and used as a credit against the taxpayer's income tax liability in any subsequent year until exhausted, subject to:~~

~~(1) The deadline for the exercise of tax credits imposed by subsection (a); and~~

~~(2) The monetary limit imposed by subsection (c).]~~

(g) The tax credits under this section shall be refundable if the amount of credit exceeds a taxpayer's tax liability for the taxable year; provided that no refund on account of the tax credit allowed by this chapter shall be made for amounts less than \$1."

II. ANTICIPATED REVENUE LOSS

This measure also provides for the funding of the investment fund's allocable credits. Currently, this program is not funded. Funding this program will result in a revenue loss to the general fund equal to whatever is appropriated.



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LATE TESTIMONY

Written Statement of
Karl Fooks
President
Hawaii Strategic Development Corporation

Before the
HOUSE COMMITTEE ON ECONOMIC REVITALIZATION, BUSINESS, & MILITARY AFFAIRS

March 11, 2010
8:30 AM
State Capitol, Conference Room 312

In consideration of

SB 2290 SD2 RELATING TO ECONOMIC DEVELOPMENT

Chair McKelvey, Vice Chair Choy and Members of the Committee:

Many states have adopted a fund of funds model to support venture capital investment in their state, indeed HSDC has been managing Hawaii's venture capital fund of funds program for many years. The focus of this bill is to create a financing mechanism that will not use scarce State fiscal resources, but still allow investment capital to be mobilized by HSDC for Hawaii's high technology companies.

Four objectives are important for financing a venture capital investment program in the current economic conditions:

- Cost to the State should be deferred for a minimum of two fiscal years.
- Potential for investment returns to offset costs should be preserved.
- Any costs incurred should be known and spread over a number of years.
- Capital should be pooled into investment funds and managed by private sector fund managers

Utilizing contingent tax credit financing mechanisms created by this bill appears to be an efficient means to meet these four objectives. The ability to defer cost from a state budgeting perspective will be determined by the earliest date the tax credits can be cashed. If that date is set for two years out, there will be no cost allocated in the budget for the first two years; if that date is set for four years out, there will be no cost allocated in the budget for the first four years, etc. However, a longer period of deferral may increase the cost of financing depending on the financing mechanism pursued.

From an economic perspective, the investments of the fund will be used to repay the capital raised from the market and therefore there is the potential for tax credits to never be cashed. In the unfortunate event where investment returns are insufficient to repay all the capital

raised from the market, the State's cost from the exercise of tax credits will be capped by the annual limits and overall program limit imposed by this legislation. The Department of Taxation has expressed concern over the credit transfer provisions of this bill, but these provisions are necessary for HSDC to sell, transfer, or assign the tax credits and thus, efficiently monetize the value of the tax credits.

Other states that are operating similar investment programs as contemplated by SB 2290 SD2 have stressed the need to provide flexibility in the enabling legislation to ensure that the cheapest means of financing can be arranged. Many of these programs are around \$100 million in total size for a ten or twelve-year program as this amount seems to support the cost of raising financing and create a presence in the venture capital industry.

There are amendments to SB 2290 SD2 that HSDC recommends to allow effective implementation of this legislation:

Page 9, Line 14: consisting of ~~six~~ five members as follows:

Page 10, Line 1: ~~(3) The chief investment officer of the employees' retirement system of the State of Hawaii.~~

Page 10 Line 14: (a) The ~~state private investment fund~~ corporation may extend one or more guarantees and secure the performance of such guarantees in the form of a put option, as well as other arrangements selected by the ~~state private investment fund corporation~~.

Page 10 Line 19: (1) To generate funds to deploy in a manner consistent with this chapter, the ~~state private investment fund~~ corporation may guarantee loans, lines of credit, and other indebtedness and equity investments and may arrange for, pledge, and assign put options, as well as other agreements to purchase tax credits on such terms as the board may approve from time to time;

Page 11, Line 13: (b) Guarantees, in whatever form negotiated by the ~~state private investment fund~~ corporation, may be made for any period of time, but no term shall expire prior to January 1, . The ~~state private investment fund~~ corporation may charge a reasonable fee for costs and the fair compensation of risks associated with its guarantee. Proceeds from the sale of any tax credits may be used to satisfy the contractual guarantee obligation of the ~~state private investment fund~~ corporation. The ~~state private investment fund~~ corporation may contract freely to protect the interest of the State.

Page 12, Line 1: (c) The guarantees extended by the ~~state private investment fund~~ corporation shall be payable solely from revenues of the fund and shall be secured solely by those revenues and by the pledges and assignments authorized by this chapter.

Page 12, Line 17: (a) Funds raised or arranged by the ~~state private investment fund~~ corporation pursuant to this chapter shall be invested by the state private investment fund in seed capital and venture capital investments;

Page 21, Line 20: (c) The tax credits shall be claimed as a refundable tax credit.

Page 23, Line 12: tax or estimated tax for the purposes of chapter 235 or 241[-], or section 431:7-202.

(g) If the tax credits under this section exceed the taxpayer's income tax liability under chapter 235 or 241, or section 431:7-202 for any taxable year, or for any other reason is not claimed by a taxpayer in whole or in part in any taxable year, the excess of the tax credit over liability, or the amount of the unclaimed tax credit, as the case may be, may be carried over and used as a credit against the taxpayer's income tax liability in any subsequent year until exhausted, subject to:

Page 24, Line 2: (h) Tax credits issued or transferred pursuant to this chapter are binding on the corporation and may not be modified, terminated, or rescinded.

Page 24, Line 4: "§211G-13 Investment [of capital.] plans; manager. ~~{(a)}~~ The ~~corporation~~ state private investment fund may solicit investment plans from investor groups for the investment of capital in accordance with this chapter. The ~~corporation~~ state private investment fund shall establish criteria for the selection of persons, firms, corporations, or other entities.

Page 24, Line 13: may be used in professional portfolio management that the ~~corporation~~ state private investment fund deems appropriate. If the ~~corporation~~ state private investment fund decides to engage one or more investment plans and investor groups that the ~~corporation~~ state private investment fund deems qualified to:

Page 25, Line 6: An investor group engaged by the ~~corporation~~ state private investment fund shall have a manager who is experienced in design and implementation, as well as the management of seed and venture capital investment programs and in capital formation.

Page 25, Line 9: programs and in capital formation. The ~~corporation~~ state private investment fund may remove

Page 29 Line 3: "(b) Seven years after the ~~corporation~~ state private investment fund has begun operations under this chapter, the corporation shall review, analyze, and evaluate the extent to which the [~~corporation~~] state private investment fund has achieved its statutory mission.

Page 30, Line 11: credits to be used by the ~~state private investment fund~~ corporation pursuant

Page 30, Line 13: SECTION 12. The state private investment fund ~~established~~ administered pursuant to chapter 211G, Hawaii Revised Statutes, is authorized

In order to allow effective implementation of the State Private Investment Fund, we suggest the following amendment to the Hawaii Revised Statutes:

§211F-4 (24) (b) Except as provided for in §211G, the ~~The~~ corporation shall not promise to answer for the debts of any other person.

In order to allow effective implementation of the State Private Investment Fund, we suggest the following amendment to Chapter 211F, Hawaii Administrative Rules:

§15-127-7 Conflict of interest; board members. ~~The corporation shall not~~ A board member shall not participate in any corporate decision to invest in, purchase from, sell to, borrow from, loan to, contract with, or otherwise deal with any person or entity in which a board member has ~~any~~ a substantial financial interest.

Thank you for the opportunity to submit testimony.

LATE TESTIMONY

Testimony of
John A. Chock
before the

HOUSE COMMITTEE ON ECONOMIC REVITALIZATION, BUSINESS, & MILITARY AFFAIRS

Rep. Angus L.K. McKelvey, Chair
Rep. Isaac W. Choy, Vice Chair

SB 2290 SD2 RELATING TO ECONOMIC DEVELOPMENT

DATE: Thursday, March 11 2010
TIME: 8:30 AM
PLACE: Conference Room 312
State Capitol
415 South Beretania Street

Chair McKelvey, Vice Chair Choy and Committee Members:

It has been said that if we're going to invest in the education of our young people, we need to invest in good, high-paying jobs for them in the future as well. For this reason I support SB 2290 SD2 which will provide support to emerging firms by providing early stage "patient" equity capital which is essential for their growth.

Hawaii's early-stage companies have done a good job on developing technology to commercialize. They are sorely hampered by a lack of access to growth capital for commercialization, and that is why this bill is so important to supporting economic diversification for our state. The approach of utilizing contingent tax credits to collateralize the capitalization of the State Private Investment Fund is highly innovative and has successfully been utilized by a number of states over the years.

Hawaii companies have been able to attract the attention of venture capital investors in limited quantities. Professionally managed funds and leveraging with private sector capital are key elements to this program, as indicators that investors are willing to take a risk on investing in Hawaii's best technology firms. This approach reduces the risk and cost to the state.

I do want to emphasize that the State Private Investment Program is not in and of itself the cure-all to growth financing for Hawaii companies. Early stage R&D through grants and credits, angel investment, venture capital for expansion, follow-on funding, and sources of debt are all discrete and necessary elements of a healthy capital market, and all are needed for Hawaii's business success. Entrepreneurial support is also a key element of that success, as the current bill recognizes.

To conclude, I have been involved in economic diversification, technology development, and capital formation for a long time in both the public and private sectors and I early on learned that it's tough to convince people to invest in diversification when the economy's strong, and there is no need for diversification. It's equally tough to promote diversification when the economy's down and it's not affordable, so a long-term vision clearly is needed. Right now is no different, and SB 2290 SD2 supports that vision.

Thank you for the opportunity to provide testimony on SD 2290 SD2.

John A. Chock
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Honolulu, Hawaii 96822



LATE TESTIMONY

Bill SB2290 SD2
Date March 11, 2010
Time 8:30am
Place Conference Room 312
Committee EBM
Chair The Honorable Representative Angus L.K. Mckelvey
Vice Chair The Honorable Representative Issac W. Choy

Aloha Chair Mckelvey, Vice Chair Choy and Members of the Committee,

Hawaii Science and Technology Council (HSTC) strongly supports SB2290 SD2

We believe that this bill will help facilitate the creation of a financial mechanism that will allow investment capital to be mobilized, as well as support Hawaii's high technology companies.

HSTC also supports the idea of HSDC (Hawaii Strategic Development Corp) managing and administering the State Private Investment Fund. They have experience in this area, as they have been overseeing venture capital fund of funds program for many years.

This financing program also makes certain that priority is given to funds committed to the State of Hawaii through physical presence, investments, as well as relationships with Hawaii based venture funds. Also, by having a financing mechanism that would utilize contingent tax credits would allow for any and all costs incurred in funding this program to be spread over few years.

We also support the recent clarification that was made through the amendment of SD2 where "the startup costs for the state private investment fund shall be funded only by the Hawaii Strategic Development Corporation". In addition, we feel that this measure takes into account and is sensitive to the current economic circumstances of the State.

Thank you for your time and consideration.

Respectfully yours,

Jamie Ayaka Moody
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