SB 753

L E G I S L A T I V E

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SUBJECT: INCOME, Extend tax credit for research activities

BILL NUMBER: SB 753, SD-1

INTRODUCED BY: Senate Committee on Economic Development and Technology

BRIEF SUMMARY: Amends HRS section 235-110.91 to require a qualified high technology business that claims the credit under this section to complete and file with the director of taxation, through the department website, an annual survey on electronic forms prepared and prescribed by the department. Requires the survey to be filed before June 30 of each year following the calendar year in which the credit may be claimed under this section.

The survey shall include: (1) identification of the industry sector in which the qualified high technology business conducts business; (2)qualified expenditures; (3) revenue and expense data; (4) Hawaii employment and wage data including the number of full and part-time employees retained, new jobs, temporary positions, external services procured by the business, and payroll taxes; and (5) filed intellectual property, including invention disclosures, provisional patents, and patents issued or granted.

The department of taxation shall use this information to prepare summary descriptive statistics by category. The information shall be reported at the aggregate level to prevent compromising identities of qualified high technology business investors or other confidential information. The department shall also identify each qualified high technology business that is the beneficiary of tax credits claimed under this section. The department shall report the information required under this subsection to the legislature by September 1 of each year.

Requires the department to use the information collected to study the effectiveness of the tax credit under this section. The department shall report on the amount of tax credits claimed and total taxes paid by qualified high technology businesses, the number of qualified high technology businesses in each industry sector, jobs created, external services and materials procured by the businesses, compensation levels, qualified research activities, and other factors as the department determines. The department shall report the results of its study to the legislature by December 1 of each year.

Extends the expiration of the tax credit for research activities from December 31, 2010 to December 31, 2015.

EFFECTIVE DATE: Tax years beginning after December 31, 2010

STAFF COMMENTS: The legislature by Act 178, SLH 1999, and Act 221, SLH 2001, enacted various tax incentives to encourage the development of high technology businesses in the state. These acts provided investment and research credits, as well as income exclusions, providing tax incentives to encourage high tech businesses and individuals associated with high tech businesses. This measure adds extensive information reporting requirements and extends the expiration of the tax credit from December 31, 2010 to December 31, 2015. While the adoption of this measure would allow the department of taxation to ascertain the effectiveness of the tax credit for research activities, such a review should have been performed a few years after the credit had been adopted.

While the proposed measure would also extend the credit for research activities until December 31, 2015, it would perpetuate the drain on state funds. It should also be remembered that the research credit is a refundable tax credit. Thus, should the amount of the credit exceed the taxpayer's income tax liability, any excess credit is a cash payment out of the state treasury to the claimant.

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 plough money into such activities is the fact that the credit provides a way to avoid paying state taxes.

A former Hawaii resident who has been a success in the field of high technology pointed out recently what will make Hawaii conducive to high tech businesses and they are: (1) entrepreneurs, not capital, that comes first; (2) entrepreneurs coming from engineering schools and technology companies; (3) building a world class engineering school in Hawaii; (4) supporting internships at technology companies; (5) allowing our best children to go away to get a worldwide perspective; (6) not broadband passing through Hawaii that is a selling point; (7) that people fly direct and therefore is Hawaii's location in the middle of the Pacific an advantage?; (8) learning the rules of the game; (9) looking at Israel and learning from them; and (10) doing your own thing, being a copy cat does not work. At the heart of his remarks was the fact that in order to produce a high technology industry in Hawaii, those companies need to have access to institutions of higher education that are producing the people needed by the high technology industry. Without the academic synergy, Hawaii will never become a center for high technology activity. Thus, all of the tax incentives, like this measure embodies, will fall short of luring high technology firms to Hawaii.

Further, the tremendous tax burden, the draconian regulatory environment, and the dramatic increase in fees that go with the permitting process make Hawaii an unattractive place to do business. It should be remembered that while the high technology credits may look like a good incentive or enticement to undertake research activities in Hawaii, those who would conduct this research must live in the same high cost-of-living environment with which other taxpayers continue to struggle. Thus, the cost of maintaining those researchers will be higher than to do so where the cost of living is much lower. Let's not bet the farm on high technology without really understanding what makes this industry tick.

Obviously the authors of this proposal would like to ignore the evaluation of these tax incentives done by UHERO a few years ago which basically condemned the credits as a waste of state resources as there is little evidence that the current program of tax credits has created substantial new employment or on-going enterprises. It is truly amazing that given the dire condition of the state's financial condition that lawmakers would continue to support unbridled drains of resources while at the same time proposing that the tax burden be increased on all other taxpayers. With declining revenues, every program from education to corrections to health services will be severely curtailed. If the state doesn't have the money to put textbooks in the schools why then do we need the highly touted, high-paying jobs the advocates for the industry promise? The next generation may not even know how to read given the cuts to the education budget.

Again, lawmakers must ask themselves whether or not this incentive is appropriate in these dire financial times. Given that there are many other proposals in the legislature to hike tax rates for either the general excise or net income taxes, taxpayers will find the continuance of these targeted business tax credits frightening. Frightening because these very lawmakers are supposed to represent the best interest of their constituents. Raising taxes on constituents while still handing out money to favored groups will engender the ire of constituents. The finger of blame for these potential increases in tax burden should not stop at lawmakers, but be placed squarely on those in the community who continue to push for these targeted tax credits. Perhaps those proponents should be asked to pick up the tab for this reckless expenditure of precious tax dollars.

While it is gratifying to know that lawmakers have finally realized that they need to evaluate the effectiveness of some of these tax incentives, it comes a tad late, but better later than never. What is appalling is that lawmakers wish to continue the credit for another five years before the evaluation is made. So no matter what the evaluation finds, the credit will go on without further review. Rather than extending it for an irrelevant period of time, the extension should be made co-terminus with the submission of the study so that policymakers can have the evaluation and recommendations before them before they decide the fate of the credit.

Finally, it should be noted that this state credit basically tracks the federal tax credit for research activities, including the disqualification for the credit should any part of the cost of the research be supported by federal grants. It would be interesting how many of the claims for this state research credit were disqualified because all or a part of the research activities were paid for with funds from federal grants.

Digested 2/23/11

The Chamber of Commerce of Hawaii
The Voice of Business in Hawaii

Comments to the Senate Committee on Ways and Means
February 24, 2011 at 9:00 a.m.
Conference Room 211, State Capitol

RE: SENATE BILL NO. 753 SD1 RELATING TO HIGH TECHNOLOGY

Chair Ige, Vice Chair Kidani, and Members of the Committee:

The Chamber of Commerce of Hawaii ("The Chamber") **supports SB 753 SD1 with amendments.**

The Chamber is the largest business organization in Hawaii, representing more than 1,100 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 its members, which employ more than 200,000 individuals, to improve the state's economic climate and to foster positive action on issues of common concern.

This bill will create and retain jobs while increasing the state's revenues. This is a prime opportunity to promote this growing sector in our state and support our small local companies in the R&D industry so that it can continue to flourish. This will allow them to provide jobs for our talented citizens and ensure that our keiki has a viable option to move back or stay in Hawaii and obtain quality jobs. Furthermore, this measure will strengthen the industry's effort to compete with other players in the national and international arena. Finally, supporting the R&D industry will help broaden and diversify Hawaii's economic base.

Proposed Amendments to SB 753

In order to sustain and maximize the outcome of this credit to benefit Hawaii's economy, the Chamber respectfully requests that the committee amends the bill, to:

SECTION 2 (j) (5), lines 3-5

- Proposed amendment: *Remove* "**invention disclosures**" (lines 3-4)
  - Justification: This would be harder to track consistently when the industry as a whole does not follow this practice, only some companies claim to track this.
- Proposed amendment: *Change* "**Filed intellectual property..., provisional patents, and patents issued or granted**" to read: **(5) Patents filed: (a) provisional, (b) full; and patents issued and granted.**

- Justification: Patents issued/granted happens after the start of the filing process, so if we just track the filed IP metric, we may not be capturing all the near term activities and results.

<u>Page 7: SECTION 2 (f), lines 4-6</u>

- Proposed amendment: *Change* definition of "Qualified high technology business" from a ~~business that conducts more than fifty per cent of its activities in qualified~~ research to **<u>a business that conducts more than fifty percent of its activities in section 41(d) research</u>**.

<u>Role and Economic Impact of the Research and Development Industry in Hawaii</u>
The large presence of all of the Nation's military services in Hawaii has spurred local companies to form and emerge into this industry. This has served as a source of funding and contracting opportunities for Hawaii's growing R&D sector, and there is considerable opportunity for even greater growth. There are literally millions of dollars that could be directed to Hawaii R&D businesses via military channels and through the prime defense contractors.

The Defense and Dual Use industry can and will play a vital role in stabilizing the state's economic climate. One of the best ways for the industry to help is to maintain and grow the workforce. Without job creation, cost cutting and tax increases will only create a downward spiral, requiring more costs and more tax increases. The state must maximize its return by spending money that generates multiples of increased spending, garnering the most return from the least amount of tax dollars.

Research and development is one of those areas. In comparing the R&D tax credit to other credits, we observe that the R&D tax credit is one of the most effective in generating and maintaining jobs per tax dollar, generating higher tax revenues for dollar spent, and stimulating measurably more economic activity in the state per dollar of tax credit.

Additionally, companies leveraging the R&D tax credits tend to be more mature companies; many on the cusp of significant expansion, which will accelerate the hiring of new employees and tax revenue.

Research and development is a highly critical component to a sustainable economy. R&D provides well-paying jobs to highly-educated employees. These employees pay significant taxes back to the state and spend considerable amounts of income within the state for goods and services. Furthermore, as the R&D matures it creates product companies that increase the number of jobs and tax base significantly.

The cost of the tax credit helps support qualified expenses in business expenditures in the state. Much of these expenditures come from imported dollars either from outside investors, the federal government or large mainland businesses. These expenditures result in income taxes and significant GET taxes.

R&D tax credit requires a company to expend its funds for which it receives a percentage (has been 20% of wages) of qualified work. This refund occurs after the company files its tax return. So, R&D tax credits for 2011 would not be paid until 2012 and most of the payments will be in the latter half of the year. Therefore, the state receives the benefits of a business base now and doesn't pay for on average 18 months later. The tax is highly focused on wages for research activities. These jobs are typically high paying and result in significant income tax revenues and GET from the money spent by these employees.

While these positive aspects are fairly defined, some have expressed concerns about the competitiveness of Hawaii's R&D tax credit levels and their refundability. However, several factors that are not considered in those concerns include:

(1) Comparisons are only made to other states and not to other countries. R&D is becoming a economic driver worldwide and Hawaii companies compete worldwide,
(2) The entire cost of doing R&D is the most important factor. Hawaii has a number of competitive disadvantages such as high income tax rates, high cost of living, high unemployment insurance costs, and high transportation costs, and
(3) R&D returns are highest when R&D turns into products, resulting in significant growth in job opportunities, increased intellectual property owned by Hawaii residents, and increased travel to the state by customers and technology related conferences.

With the loss of federal support that helped sustain R&D companies in a high-cost environment, the importance of a refundable R&D tax credit is even more prevalent and which will help keep existing businesses viable in Hawaii.

<u>Summary</u>
In summary, the Hawaii R&D tax credit has been effective in generating new taxes, creating new companies and employing a number of residents. Therefore, it is important that a gap does not exist in the R&D tax credit while the 2011 legislature addresses the longer term impact of R&D on the state. Companies need to make long term plans when doing R&D. It is critical to the industry that the tax credit be in place long enough to encourage R&D and its commensurate high paying jobs, job growth, and its direct impact on the sustainability of the state's economy.

Therefore, we respectfully ask that the committee to **pass this measure with the proposed amendments**. Thank you for the opportunity to provide testimony.

HTDC Cultivating Hawaii's tech sector
HIGH TECHNOLOGY DEVELOPMENT CORPORATION

Written Statement of

YUKA NAGASHIMA
Executive Director & CEO
High Technology Development Corporation
before the
SENATE COMMITTEE ON WAYS AND MEANS
February 24, 2011
9:00 AM
State Capitol, Conference Room 211

In consideration of
SB 753 SD1 RELATING TO HIGH TECHNOLOGY.

Chair Ige, Vice Chair Kidani, and Members of the Committee on Ways and Means.

The High Technology Development Corporation (HTDC) supports SB 753 SD1, which reinstates the Research and Development Tax Credit, and offers some suggestions to further improve the bill. The state tax credit for research activities will sunset at the end of calendar year 2010. This tax credit program was an effective measure to support research and development activities which in turn, foster and encourage the innovation essential to create high-wage job opportunities in our economy. Over the past nine years, the tax credit claims under this program averaged approximately $11 million a year. As the credit can only be claimed for actual expenditures made in Hawaii and only for 20% of the qualified expenditures, the cost of the program is partially offset by taxes paid on expenditures and payroll.

HTDC's recommendations to further improve this important measure are as follows:

1. Remove "Invention disclosures" from the list of reporting requirements, as this process is not consistently practiced within the industry and is an internal process difficult to audit. Many R&D companies may be unfamiliar or confused by the term. While this process is a reflection of R&D activities, it is a poor metric for the State's purpose because it is not consistently practiced among the industry members.

2. Clarify the patent reporting requirements as "Patents filed" (whose category can be subdivided into provisional patents and full patents), and "Patents issued/granted". This distinction would better capture the vibrant activities of the R&D companies in time, as the patent review process is lengthy and it may be years before a full patent is granted.

3. Replace the word "qualified" with "41 (d)" on page 7, line 6. Directly referring back to 41 (d) rather than "qualified research", a term defined in the subsequent lines used to qualify expenses, would better distinguish factors for <u>companies to qualify vs. expenses qualified</u> for tax credits.

4. HTDC also recommends that after the sets of information are collected by DoTAX that DBEDT be given the aggregated, anonymized data for analysis so that DBEDT may provide an appropriate economic impact report to the legislature. Because this is an economic stimulus measure, it is not sufficient for the legislature to know the immediate liabilities to the State. We must also take into account the income, payroll and other taxes these companies must have already paid in order to receive the R&D tax credits. The DBEDT staff is better suited to such analyses, given proper resources, to factor in the economic multipliers and produce impact reports. Doing so will bring further synergy to other reports that DBEDT is already mandated to provide (e.g., emerging industries report, etc.).

Thank you for the opportunity to submit testimony on this bill.

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February 23, 2011

Comments to the Senate Committee on Ways and Means
Thursday, February 24, 2011, 9:00 a.m.; Conference Room 211

RE: SENATE BILL NO. 753 RELATING TO HIGH TECHNOLOGY

Chair Ige, Vice Chair Kidani, and members of the committee:

My name is Rick Holasek and I am the President and CEO of NovaSol, a high technology aerospace/defense company based in Honolulu. I strongly support Senate Bill 753 relating to High Technology. This bill seeks to continue the very successful R&D tax credit in Hawaii that has helped foster high technology job creation and retention.

Historically, the R&D credit has allowed development and testing work that has created several jobs for highly skilled workers that are the very types of jobs that Hawaii needs most. These are high paying technical positions with staff that foster growth in the technology field in general. While technology jobs account for about 5 percent of the workforce in Hawaii, they produce closer to 10% of the revenue conducted within the State.

In addition, for small businesses, the R&D credit is often the basis on which companies decide to locate and/or stay here as opposed to other states that offer similar and additional incentives. With the recent significant loss of future revenues due to the continuing resolution in the federal government and additional loss of earmark monies to Hawaii, the technology sector is already pressed in developing alternative sources of revenue. The R&D credit is more meaningful now than ever before.

For these reasons, I respectfully ask that you pass this measure. Please feel free to contact me at any time if you have questions or comments.

Sincerely,

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Comments to the Senate Committee on Ways and Means
Thursday, February 24, 2011
9:00 a.m.
Conference Room 211
RE: SENATE BILL NO. 753 RELATING TO HIGH TECHNOLOGY

Chair Ige, Vice Chair Kidani, and members of the committee:

I am an testifying as an individual employed by a large defense contractor who supports a strong, growing supplemental industry to tourism, and defense, I respectfully submit comments in conceptual support of SB753 (SD1). SB 753 (SD1) renews the research and development (R&D) tax credit contained in Section 235-110.91 HRS. The state tax credit for research activities (Act #221) was sunset at the end of calendar year 2010. This tax credit program was an effective measure to support research and development (R&D) activities, which in turn, foster and encourage the innovation essential to create high-wage job opportunities in our economy. Over the past nine years, the tax credit claims under this program averaged approximately $11 to $15 million a year, per prior DoTax testimony. As the credit can only be claimed for qualified research entities (QHTB) conducted in Hawaii and only for 20% of the qualified expenditures (prepaid to the State), the cost of the program is partially offset by taxes paid on expenditures and payroll and represents a diversified, clean, high paying industry where our STEM graduates can be employed.

The legislature has had the foresight to fund STEM programs, and the effort has now produced robotics programs in over 500 Hawaii schools....the numbers are growing! Our students compete favorably with any of their mainland counterparts as exemplified by the performance of our local teams in FIRST (robotics) national competition and the national first place wins by Iolani and Hanalani Schools in the Department of Energy sponsored national 2009 "Real World Design Challenge", and the 2010 Botball National Championship. Our kids just need a chance.... and most want to be employed in Hawaii.

We need strong locally based companies to employ this growing inventory of bright young folks. We should not be educating them to move to the mainland for work. We need their skill sets to move our economy forward in this computer age where STEM skills are absolutely necessary!

Thank you for the opportunity to submit testimony on this bill and respectfully ask your support. If asked, I will be glad to answer any questions.

Mahalo,

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