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To: The Honorable Angus L.K. McKelvey, Chair;
The Honorable Lisa Kitagawa, Vice Chair;
and Members of the House Committee on Economic Development & Business

From: Rona M. Suzuki, Director
Department of Taxation

Re: **H.B. 1685, Relating to Taxation**
Date: Wednesday, February 12, 2020
Time: 10:45 A.M.
Place: Conference Room 309, State Capitol

The Department of Taxation (Department) has serious concerns about H.B. 1685 and offers the following comments.

H.B. 1685 creates a new, nonrefundable income tax credit for cybersecurity and artificial intelligence business investment. The credit is equal to 100% of the investment made by the taxpayer in the business, provided it is taken over a five-year period, and capped at a maximum amount that may be claimed per year. If the business invested in no longer qualifies as a cybersecurity or artificial intelligence business any time during the five-year claiming period, the amount claimed by taxpayers is subject to a 10% recapture.

Taxpayers claiming the credit are required to submit a written, sworn statement to the Department which the Department must certify. The credit is also made available for taxpayers under chapters 241 (the Taxation of Banks and Other Financial Corporations), Hawaii Revised Statute (HRS) and 431 (the Insurance Code), HRS. Transactions where the investment tax credit allocation ratio is 1.5 or less are presumed to satisfy the economic substance doctrine. Transactions where the ratio is greater than 1.5 and up to 2.0 may be reviewed by the Department. Transactions where the ratio is greater than 2.0 require the taxpayer to proactively substantiate economic substance and business purpose. The tax credit established by this bill applies to taxable years beginning after December 31, 2019.

The Department has the following concerns with this measure:

1. Proposed section (a) provides the credit based on the **investment** into a "qualified entity." The measure defines a "qualified entity" in terms of the amount of activity and income from the development of cybersecurity and artificial intelligence. Substantial credit could thus be generated by simply investing in an entity, regardless of how much research is actually performed because the thresholds are measured in percentages. The Department suggests amending the measure so that qualification for the credit is contingent on more than just an investment;
2. A 100% tax credit does not promote efficient use of State resources. With a 100% credit, the State bears all the risk of the investment because the taxpayer will receive an amount

equivalent to their investment in tax credits. The State would provide tax credits on investment no matter how low the chance of economic viability of the "qualified entity" is. Thus, every taxpayer/investor would be provided a risk-free opportunity to earn money on their investment. The Department suggests reducing the credit percentage so that some of the risk is shifted to the taxpayer/investor;

3. The Department is not the appropriate body to certify expenses that may be claimed for this credit. The Department lacks the subject matter expertise to certify whether expenses constitute an investment in a cybersecurity or artificial intelligence business and respectfully suggests the Legislature select another agency that is capable of such a certification. In addition, it is not appropriate for the Department to perform pre-filing certification as it has authority to examine and adjust all returns and claims for credits under Title 14, HRS. Pre-filing certification of a credit will be misinterpreted as an approval;
4. The 10% recapture provision in subsection (d) is not sufficient. If any of the three recapture events are triggered only a fraction of what was allowed as a credit is recaptured. The Department suggests amending the recapture provision so that at least 50% of the credit claim for all years is recaptured;
5. The measure fails to specify whether the tax credit is claimed at the entity level or the individual level for partnerships, LLCs, etc. The Department suggests specifying that the credit is claimed at the entity level as to avoid any loopholes that may result in untended and greater-than-expected revenue losses;
6. The Department requests that subsection (h) be deleted. The common law principles of economic substance and business purpose already apply to all tax credits. The Department has the authority to review all claims for credit and all tax returns, including requesting additional substantiation, auditing returns, and adjusting any claims for credit. The language in subsection (h) arguably proscribes the Department's otherwise clear authority to do so;
7. Unlike the QHTB credit, H.B. 1685 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; and
8. Finally, the Department respectfully requests any new tax credits be made effective for taxable years beginning no earlier than December 31, 2020, to give the Department time to update its forms and computer system. Furthermore, by making this measure effective for tax years which have already begun, the State would be creating a tax incentive for economic actions that have already occurred.

Thank you for the opportunity to provide comments.

Hawaii Technology Development Corporation
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Written Statement of
Len Higashi
Acting Executive Director
Hawaii Technology Development Corporation
before the
House Committee On Economic Development & Business
Wednesday, February 12, 2020
10:45 a.m.
State Capitol, Conference Room 309

In consideration of
HB1685
RELATING TO TAXATION.

Chair McKelvey, Vice Chair Kitagawa, and Members of the Committee.

The Hawaii Technology Development Corporation (HTDC) offers **comments** on HB1685 that establishes an income tax credit for investment in qualified businesses that develop cybersecurity and artificial intelligence.

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 growing tech and innovation jobs. HTDC agrees that cybersecurity and artificial intelligence are technologies with great potential for the State. HTDC, through the TRUE initiative partnership, is supporting the private sector in their artificial intelligence technology implementations. Through our INNOVATE Hawaii program, HTDC is supporting manufacturers with cybersecurity audits for federal regulation compliance. The demand for new technologies in these areas in apparent. At the same time, with the increased priority for implementation of these technologies, it may be difficult to distinguish between new product development and product customization. HTDC believes that a grant program may more clearly allow economic development criteria to be tied to awards. HTDC looks forward to working with all stakeholders in moving the innovation economy forward.

Thank you for the opportunity to offer these comments.

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, FRANCHISE, INSURANCE PREMIUM, Tax Credit for Cybersecurity and Artificial Intelligence

BILL NUMBER: HB 1685

INTRODUCED BY: SAY, BROWER, CREAGAN, KONG, LUKE, TOKIOKA, WARD, Hashimoto

EXECUTIVE SUMMARY: Establishes an income tax credit for investment in qualified businesses that develop cybersecurity and artificial intelligence.

SYNOPSIS: Adds a new section to chapter 235, HRS, to establish the cybersecurity and artificial intelligence business investment tax credit. It is a nonrefundable credit closely tracking the provisions of the now-expired high technology business investment tax credit, HRS section 235-110.9. The amount of the credit is 100% of the amount of investment in a qualified business, spread over five years.

Defines a qualified business as a business, employing or owning capital or property, or maintaining an office, in this State; provided that: (1) more than fifty per cent of its total business activities are the development of cybersecurity and artificial intelligence; and provided further that the business conducts more than seventy-five per cent of these development activities in this State; or (2) more than seventy-five per cent of its gross income is derived from the development of cybersecurity and artificial intelligence; and provided further that this income is received from: (A) products sold from, manufactured in, or produced in this State; or (B) services performed in this State.

Administrative provisions relating to this new credit are like those under HRS section 235-110.9.

New sections are added to chapter 241 and chapter 431, HRS, to make the credit applicable to the financial institution franchise tax and the insurance premium tax respectively.

EFFECTIVE DATE: This Act shall take effect upon its approval; Section 1 of this Act shall apply to taxable years beginning after December 31, 2019, for investments made pursuant to section 235- , Hawaii Revised Statutes, on or after the effective date of this Act; 9 and (2) Section 4 of this Act shall apply to taxable years beginning after December 31, 2019.

STAFF COMMENTS: The first, and considerable, hurdle is to define what businesses are going to be eligible for this credit. Cybersecurity and artificial intelligence are not well defined. If I write a small macro that helps me do repetitive tasks in Word and/or Excel, for example, have I created artificial intelligence? Having a loose definition tends to attract lots of attention, not necessarily from the businesses intended to be benefited, especially when the credit amount is substantial, as it is here.

Next, the Legislature should be thinking long and hard about its experience with the QHTB investment credit in section 235-110.9, HRS. For those who think that the QHTB businesses took the people of Hawaii for a ride with this credit, are we to expect that the same experiences will not befall us this time as well?

Utilizing tax credits to drive economic policy in this manner is of a questionable benefit relative to the cost for all taxpayers. A direct appropriation of grant funding to producers would be more accountable and transparent. At least we would know the amount of the appropriation, while the fiscal impact of the credit would be a great big question mark.

Furthermore, the additional credit would require changes to tax forms and instructions, reprogramming, staff training, and other costs that could be massive in amount compared to the benefit expected to accrue because of the creditable activity.

Digested 2/10/2020