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

ON THE FOLLOWING MEASURE:
H.B. NO. 2716, H.D. 1, RELATING TO TAXATION.

BEFORE THE:
HOUSE COMMITTEE ON FINANCE

DATE: Monday, February 24, 2020 **TIME:** 12:00 p.m.

LOCATION: State Capitol, Room 308

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

Chair Luke and Members of the Committee:

The Department of the Attorney General has concerns about this bill and provides the following comments.

The purpose of H.B. No. 2716, H.D. 1, is to "establish an ocean science research income tax credit to foster research and development to expand and diversify Hawaii's economy." *See* H.B. No. 2716, H.D. 1, page 2, lines 3-5. A "small business" would be entitled to this research tax credit so long as it has "(1) Fewer than one hundred employees; and (2) <u>An office located in the State.</u>" <u>Id.</u>, page 5, lines 14-16. (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." <u>Oregon Waste Sys., Inc. v. Dep't of Envtl. Quality</u>, 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 because it is unlikely that a business with less than 100 employees located outside of the State would have an office located in the State; whereby 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 nondiscriminatory way to do this is by removing the phrase “An office located in the State” from the definition of “small business” so that businesses engaged in research and development in the field of ocean sciences may take advantage of the tax credit regardless of where their offices are located. Thank you for the opportunity to express our concern.

DAVID Y. IGE
GOVERNOR

JOSH GREEN M.D.
LT. GOVERNOR

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To: The Honorable Sylvia Luke, Chair;
The Honorable Ty J.K. Cullen, Vice Chair;
and Members of the House Committee on Finance

From: Rona M. Suzuki, Director
Department of Taxation

Re: **H.B. 2716, H.D. 1, Relating to Taxation**
Date: Monday, February 24, 2020
Time: 12:00 P.M.
Place: Conference Room 308, State Capitol

The Department of Taxation (Department) provides the following comments regarding H.B. 2716, H.D. 1.

H.B. 2716, H.D. 1, establishes the ocean sciences research tax credit up to an unstated amount. The credit is equal to the actual cost paid with an investment made into the qualified entity. H.B. 2716, H.D. 1, has a defective effective date of July 1, 2050 and is repealed for taxable years beginning after December 31, 2025.

The Department first notes that **it is unclear how the credit would be calculated as it is based on actual costs paid with an investment made into a qualified entity**. Since the qualified entity is the taxpayer performing the research, it is not clear what costs the qualified entity would be paying. The Department suggests clarifying this provision.

In its current form, **this measure is substantially similar to the tax credit for research activities provided under section 235-110.91, Hawaii Revised Statutes**. The Department suggests amending that credit instead of enacting a completely new credit that overlaps with an existing credit.

Finally, if a functional effective date is to be inserted, the Department respectfully requests that this new credit be made available for taxable years beginning after December 31, 2020. This will allow sufficient time to make the necessary form and computer system modifications.

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: HB 2716, HD-1

INTRODUCED BY: Senate Committee on Water, Land, & Hawaiian Affairs

EXECUTIVE SUMMARY: Establishes the ocean sciences research tax credit. Effective for tax years beginning after January 1, 2050.

SYNOPSIS: Adds a new section to chapter 235 to establish a nonrefundable tax credit for each small business subject to income tax equal to the actual cost paid with an investment into a "qualified entity" for research and development in the field of ocean sciences. The amount of the credit is 100% of the actual cost paid with an 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: Upon approval, shall apply to taxable years beginning after January 1, 2050.

STAFF COMMENTS: This bill contains many technical issues. Among them:

- Subsection (b)(1) allows credit for 100% of the "actual cost paid with an investment made into the qualified entity." Does that mean the amount of investment, or is the bill trying to give credit for certain costs?

- 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 (we think), 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 2/21/2020

Written Only

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

HOUSE COMMITTEE ON FINANCE

Monday, February 24, 2020
12:00 pm
State Capitol, Conference Room 308

in consideration of
H.B. 2716 H.D.1
RELATING TO TAXATION.

The Natural Energy Laboratory of Hawaii Authority (NELHA) supports the intent and is pleased to comment on H.B. 2716 H.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.

LATE

Statement of
Hermann Kugeler
Business Development Manager
Makai Ocean Engineering, Inc.
before the
House Committee on Finance
Monday, February 24, 2020
12:00pm
State Capitol, Conference Room 308
In consideration of
HB2716
RELATING TO TAXATION.

Chair Luke, Vice Chair Cullen, and Members of the Committee.

Makai Ocean Engineering, Inc. **SUPPORTS HB2716, 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 Hawaii's community vibrant and the 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 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 as a result of research and development contributes greatly to economic growth. It is oftentimes 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 the State's economy and create a wide range of high-skilled, high-paying jobs for 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 income 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 ~~small business~~ 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 tax liability, if any, imposed by this chapter.

(b) The amount of the tax credit shall be equal to the actual cost ~~paid with an~~ of an investment made into the qualified entity ~~for research and development in the field of ocean sciences~~; provided that:

~~(1) A qualified entity may form a special purpose entity for the purposes of raising investor capital and claiming the credit on behalf of the qualified entity;~~

(2) The ~~qualified entity, together with all of its special purpose entities, including all partners and members of the qualified entity and its special purpose entities,~~ 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

(3) In no event shall a ~~qualified entity or any of its special purposes entities, 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) This section shall not apply to taxable years beginning after December 31, 2025.

(g) 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.

(h) For the purposes of this section:

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

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"Qualified entity" means an entity which has been doing business for at least five years with the principal purpose of research and development as defined by the National American Industry Classification System code 541715 in the field of ocean sciences ~~as defined by the National American Industry Classification System code 541715~~.

"Small business" means a business with:

1) Fewer than one hundred employees; and

(2) An office located in the State."

SECTION 3. New statutory material is underscored.

SECTION 4. This Act, upon its approval, shall apply to taxable years beginning after January 1, 2050."

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 HB2716** 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.

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