LINDA LINGLE
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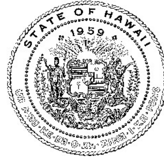
LT. GOVERNOR



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October 9, 2009

[redacted text]
Honolulu, HI [redacted text]

RE: Partnership Allocations of High Technology Business Investment Tax Credit for **[redacted text]**

Dear [redacted text]:

This letter responds to your request of October 6, 2009 as supplemented by your emails of October 6 and 7, 2009 from **[redacted text]** (the "Company") requesting a ruling from the State of Hawaii Department of Taxation (the “Department”) that the Company's methodology of allocating the High Technology Business Investment Tax (“HTBIT)" credits for investments made on or after May 1, 2009 complies with the requirements of Section 235-2.45(d), Hawaii Revised Statutes ("HRS"), as amended by Act 178, Session Laws of Hawaii 2009 ("Act 178 SLH 2009").

SHORT ANSWER

Based on the information in your request and the representations made by the Company, the Company’s method of allocating HTBIT credits for investments made on or after May 1, 2009 complies with HRS § 235-2.45(d), as amended by Act 178 SLH 2009.

FACTS REPRESENTED BY THE COMPANY

The Company is a Hawaii limited liability company treated as a partnership for federal and state tax purposes. It is the sole member of [redacted text] (“[redacted text]”), which is a QHTB, as defined in HRS § 235-7.3 and HRS § 235-110.9 and has received a comfort letter ruling from the Department dated [redacted text]. In addition, the Company is the sole member of [redacted text] ("[redacted text]"), which is not a QHTB. Both [redacted text] and [redacted text] are disregarded entities for tax purposes.

The Company and [redacted text] develop and provide software, other technology products and other services that promote innovation and consumer improvements in healthcare. Their goal is to leverage technology to reduce the cost and improve the quality of healthcare and eldercare.

The Company has authorized the issuance of up to [redacted text] Preferred Units to raise up to [redacted text] in capital contributions of cash to the Company ("Preferred Financing"). The Company's Agreement provides that the Company shall immediately invest all cash proceeds from the Preferred Financing into [redacted text] as QHTB Investments.

The Company raised approximately [redacted text] in Preferred Financing from the sale of Class D Units, Class E Units, and Class F Units on or before December 31, 2008, and the Company invested all of the proceeds into [redacted text] as QHTB Investments on or before December 31, 2008. For such QHTB investments made by the Company prior to May 1, 2009, the Company's Agreement provides for disproportionate allocations of HTBIT credits among its Members, as allowed under HRS § 235-2.45(d) for QHTB Investments made prior to May 1, 2009. The allocations of HTBIT credits received from QHTB investments made prior to May 1, 2009 ("Prior Credits") are not the focus of this Ruling and shall continue to be allocated to the holders of Class D, Class E and Class F Units in accordance with the Company's Agreement and as permitted by HRS § 235-2.45(d) prior to its amendment by Act 178 SLH 2009. The Prior Credits attributable to investments made by the Company prior to May 1, 2009 shall continue to be allocated solely to the Members holding Class E Units and Class F Units in accordance with the Amendments in Exhibit A.

The Company is continuing to raise additional capital pursuant to the Preferred Financing, the proceeds of which the Company will invest in [redacted text] as QHTB Investments made on and after May 1, 2009 ("New QHTB Investments"). The Company will create two new classes of Preferred Units for capital contributions received by the Company on or after May 1, 2009. Capital contributions received by the Company on or after May 1, 2009 and through and including December 31, 2009, shall be designated "Class G Units." Capital contributions received by the Company on and after January 1, 2010 and through and including December 31, 2010 shall be designated "Class H Units." The Company shall immediately invest the cash proceeds it receives in consideration of its issuance of Class G Units and Class H Units into [redacted text] as QHTB Investments.

The Company is amending its Agreement, pursuant to the amendments in substantially the form attached hereto as Exhibit A (the "Amendments"), for purposes of complying with IRC § 704(b)(2) and HRS § 235-2.45(d), as amended by Act 178 SLH 2009, with respect to the allocation of HTBIT credits that the Company earns from the QHTB investments made on or after May 1, 2009. The Amendments provide that all HTBIT credits earned by the Company from QHTB investments made by the Company with proceeds of capital contributions received by the Company in consideration for Class G Units shall be allocated exclusively to the members holding Class G Units ("Class G Members"), as a class, and to each of the Class G Members in proportion to their respective numbers of Class G Units held. Similarly, the Amendments also provide that all HTBIT credits earned by the Company from QHTB Investments made by the Company with proceeds of capital contributions received by the Company in consideration for Class H Units shall be allocated exclusively to the members holding Class H Units ("Class H Members"), as a class, and to each of the Class H Members in proportion to their respective numbers of Class H Units held.

The Company will further amend the Agreement attached as Exhibit A to allow for the creation of subclasses within Class G and H to identify units issued at different times of the year or at different unit prices.

The Company represents that only cash investments made by the Company into [redacted text] which meet the definition of "investment" as set forth in HRS § 235-1 will be the basis for determining the HTBIT credits that the Company allocates to its members and that the Company will not use investment of non-cash items to claim or allocate HTBIT credits. Monies from the post May 1, 2009 investors are traceable to [redacted text] by being kept segregated from all other monies of the Company until it is directed to [redacted text]. [Redacted text] then expends such funds for its operating requirements. When the investment proceeds are expended by the QHTB, it is expected that substantially all the losses of the QHTB will be allocated to the Class G & H units based upon the current projections of the member's capital account balances in the year of expenditure

The Company further represents that the Agreement and Amendments, including the direction and use of investment monies and the profit and loss allocation provisions have substantial economic effect in accordance with IRC § 704. The allocation of the credits will be made in accordance with Section 8.4 of the Agreement which is substantially based on the loss allocation as described in Sec 8.1(a)(iv)(C) and Sec 8.1(a)(iv)(D).

LAW AND ANALYSIS

HRS § 235-110.9 provides a tax credit for investments made in a QHTB, including investments made by entities treated as partnerships for income tax purposes. The credit is based on investments made in QHTB and is not dependent on the expenditures made by the QHTB. For investments made in taxable years beginning after December 31, 2000, but before taxable years beginning after December 31, 2010, up to $2,000,000 in credit per taxpayer is available. The credit is graduated over five years (35% to 10%) from the date of the "investment" in a QHTB for investments made in tax years 2001 to 2010. The credit is capped at varying amounts ($700,000 in the year the investment is made to $200,000 in the last year). If the tax credit exceeds the taxpayer's income tax liability for any of the five years that the credit is taken, the excess of the tax credit over liability may be used as a credit against the taxpayer's income tax liability in subsequent years until exhausted.

HTBIT credits are generated at the time of investment and not at the point of expenditure which may be in a later tax year and is generated without respect to the day of the year. Therefore, a calendar year investor who makes a QHTB investment on December 31st of a year would be entitled to the full credit of 35% of their investment in the year of investment, even though the investment was made on the last day of the tax year of the investor.

For investments in QHTB's made prior to May 1, 2009, partners may be allocated HTBIT credits in amounts that are not proportionate to the amounts of their respective investments, since

§ 235-2.45(d) HRS provided that IRC § 704(b)(2) was not operative for purposes of allocating the HTBIT credit.

Act 178 SLH 2009 added additional restrictions for investments received on or after May 1, 2009 and on or before December 31, 2010, including:

- Not more than 80% of a taxpayer's tax liability may be offset by utilizing such credits for tax years ending on or before December 31, 2010;
- The credit must be taken ratably over the five year period in accordance with §235-110.9(a), HRS and may not exceed an Investment Tax Credit Allocation ratio of 1:1;
- No carryover of any unused credits from investments made on or after May 1, 2009 for tax years ending on or before December 31, 2010; and
- IRC § 704(b)(2) is operative for partnership allocations of HTBIT credits received from investments made by the partnership into a QHTB.

The purpose of the amendment to HRS § 235-2.45(d) made by Act 178 SLH 2009 was to require partnerships to allocate HTBIT credits in proportion to the amounts of partners' investments in the partnership attributable to the QHTB investments made by the partnership for investments made on or after May 1, 2009. This is consistent with the underlying purpose of IRC § 704(b), which is to have tax consequences follow economics. See McKee, Nelson & Whitmire, Federal Taxation of Partnership and Partners, Paragraph 11.02[2] (4th ed. 2007) ("McKee").

IRC § 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall normally be determined in accordance with the partnership agreement. However, IRC § 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall be determined in accordance with the partner's interest in the partnership determined by taking into account all facts and circumstances, if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit, or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit does not have substantial economic effect.

An allocation is in accordance with the members' interests in a limited liability company taxed as a partnership ("LLC") if each member's percentage interest in income, losses, and interim distributions is the same as the percentage of the LLC's capital contributed by the member. Any deviation from such an allocation results in a special allocation. The regulations for IRC § 704(b) provides three ways that the special allocation will be respected:

1) The allocation has substantial economic effect; or

2) the allocation is in accordance with the partner's interest in the partnership taking into account all facts and circumstances; or

3) the allocation can be deemed to be in accordance with the partner's interest in the partnership under one of several special rules contained at (b)(4) of the regulations.

Whether a partnership has made a special allocation, and if so, whether it's effective for tax purposes, is ordinarily determined under the substantial economic effect test. The term "special allocation" does not appear in the IRC itself but does appear in the regulations and the legislative history to the Tax Reform Act of 1976 (S. Rep No. 938, 94th Cong., 2nd Sess 98 (1976). The idea for partnership special allocations originated with the American Law Institute in 1954 and was limited only if the principal purpose for the allocation was the avoidance or evasion of income tax. The report of the Senate Finance Committee that accompanied that 1954 provision used the term "substantial economic effect" in commenting on whether an allocation would be valid. This term also appeared in the original regulations for subchapter K of the 1954 Code and contained six tests to evaluate whether or not a special allocation would be respected.

The original language of IRC §704(b) was amended by the Tax Reform Act of 1976 which strengthened the limitation by prohibiting any allocation which does not have "substantial economic effect." While prior to 1976, the "substantial economic effect" language was only in the regulations and not within the statute, cases decided under the 1954 Code noted that "substantial economic effect" was the key factor, and in its absence the remaining regulation 1.704-1(b)(2) factors could not redeem the allocation. See Ogden v. Commissioner, 788 F.2d 252, 261 (5th Cir.1986) ("1976 revision of section 704(b)(2) was less substantive than it may appear; even under the prior law it was stated that 'An allocation that lacks "substantial economic effect" will not be saved' " by the other factors) (citation omitted); Hamilton v. United States, 687 F.2d 408, 414, 231 Ct.Cl. 517 (1982) ("An allocation that lacks 'substantial economic effect' will not be saved by meeting the other five factors in the regulation.").

As amended by the Tax reform Act of 1976, section 704(b) provides that any income, gain, loss, deduction, or credit may be allocated under the partnership agreement if the allocation has substantial economic effect. Under Reg. § 1.704 (b)(2)(i) there is a two part test for evaluating the allocation:

1) it must have economic effect; and

2) it must be be substantial.

ECONOMIC EFFECT

An allocation must have economic effect which means that it must be consistent with the underlying economic arrangement of the members. Any special allocation which creates a benefit or burden for a partner must assign all ultimate economic responsibility for the allocation

to the partner receiving the benefit or burden. Reg. § 1.704 (b)(2)(ii)(b) sets forth a three part safe harbor provision which satisfies the economic effect requirement, provided that throughout the full life of the partnership all three criteria are met:

1) the partners' capital accounts are maintained using book accounting rules;

2) at liquidation of the partnership or the liquidation of any partner's interest in the partnership, liquidating distributions will be based on the positive amounts in the partner's capital accounts; and

3) if a partner has a deficit balance in his capital account after liquidation, the partner is unconditionally required to make a contribution to the partnership to bring the deficit amount up to zero.

Because members of a LLC have limited liability and provisions requiring the contribution of additional capital are rarely included in LLC operating agreements because it eliminates the members' limited liability, a special allocation would normally fail the safe harbor and generally no allocation made by an LLC would be effective for tax purposes unless it's either in accordance with the members' interests in the LLC within the meaning of IRC § 704(b) or is deemed to be in accordance with the members' interests under the income tax regulations.

Reg. § 1.704 (b)(2)(ii)(d) however provides an alternative test for economic effect if the first two tests are met above. Called a qualified income offset, it provides for a limited deficit restoration obligation but generally does not require contributions to satisfy other partners' positive capital accounts. The alternative is satisfied if the partner who receives the special allocation is obligated to restore a limited amount of deficit and any special allocation to the partner does not create a deficit larger than the amount the partner is required to restore. The ending balance in the partner's capital account should take into consideration adjustments, allocations of loss and deductions, and distributions that are reasonably expected to be made by the end of the tax year. A qualified income offset requires the partnership to allocate income to the partner who unexpectedly receives an allocation, adjustment, or distribution in an amount to eliminate the deficit as quickly as possible. The income and gain items must consist of a pro rata amount of each item of the LLC's income for the year, including gross income and gain. If the LLC agreement contains a "qualified income offset provision" a member may be allocated losses without being required to restore a capital account deficit. If an allocation creates a deficit beyond the amount required to be restored, the excess amount of the allocation is disallowed and only a proportionate amount of all special items will be allocated to the partner. A year-end change in the amount of deficit the partner must restore will not invalidate prior allocations if the ending deficit does not exceed the amount of deficit the partner must restore after the change.

A third test for economic effect is found in the "deemed" equivalence provisions at Reg. § 1.704 (b)(2)(ii)(*i*). Even if the safe harbor tests are not met, an allocation will be deemed to have economic effect if at the end of the partnership tax year, a liquidation of the partnership

would produce the same economic results to the partners that would have occurred under the safe harbor provisions.

SUBSTANTIAL

Generally, an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership independent of the tax consequences. An allocation is not substantial if at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may be enhanced compared to such consequences if the allocation were not contained in the partnership agreement and (2) there is a strong likelihood that the after-tax consequences of no partner will be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreements.

An allocation is not substantial if at the time the allocation becomes part of the partnership agreement, the after-tax consequence of at least one partner, may, in present value terms, be enhanced by the allocation and there is a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished over the life of the partnership. These are known as shifting allocations since they shift tax consequences between the partners, decreasing the aggregate tax liability in the year of the shift without materially affecting the partners' capital account balances

Likewise, transitory allocation lack substantiality. A transitory allocation is one that shifts tax consequences between the partners, decreasing aggregate tax liability over more than one year but without affecting the partners' capital account balances over a five (5) year period.

APPLICATION TO THE HTBIT CREDIT

Under IRC § 704(b), allocations of tax credits do not impact the partners' capital accounts and have no effect on the dollar entitlements of the partners in terms of cash distributions or cash upon liquidation. See Reg. § 1.704-1(b)(4)(*ii*). While an allocation of a credit cannot have substantial economic effect, Reg. § 1.704-1(b)(4)(*ii*) provides if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) is in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments) and the credit will be allocated in the same manner as the loss or deduction which decreases the partners' capital accounts.

The HTBIT credit is intended to encourage investors to make investments in a QHTB by providing a tax credit based on a percentage of the investment made by the investors each year, subject to certain limitations. Allocating the HTBIT credits generated in the year of investment strictly in accordance with the expenditures or losses of the partnership in the year of investment may result in an allocation of HTBIT credits that does not necessarily match the intended

economics of the Members or the legislative intent of Act 178 SLH 2009, which was to limit an investor's share of credits to 100% of the investor's investment. In the instant case, the Company has represented that the losses or profits of the partnership allocated to the various classes of investors and the allocations to the members within each class based on their pro rata interest in such class have substantial economic effect under IRC § 704(b). The Company has also represented that that substantially all the losses of [redacted text] when the investment monies are expended will be allocated to the Class G & H units based upon current projections of the member’s capital account balances in the year of expenditure. While the losses resulting from the investment monies being expended may not occur until a following year, the allocation of the HTBIT credits based on the losses allocated to the class in the year of investment is substantially the same allocation that would occur when the monies are in fact expended. For example, if a Class G investor is allocated (based upon his pro rata interest in the class) 10% of the loss or profit allocated to the class, that investor would also be allocated 10% of the credits that were generated by the class. Since no new units of the same class may be issued once the tax year has closed, that same investor would receive the same pro rata allocation of loss or profit in the following years.[1] Thus, the investor would be obtaining the ratio of loss or profit that is generated on account of his investment which gave rise to a valid allocation of such loss or profit over time. Accordingly, based solely on the Company's representations, the Company's method of allocating HTBIT credits satisfies HRS § 235-2.45(d), as amended by Act 178 SLH 2009, subject to any limitations as set forth in HRS § 235-110.9 as amended by Act 178 SLH 2009.

CONCLUSION

Based solely on the representations, the Company’s method of allocating HTBIT credits satisfies HRS § 235-2.45(d), as amended by Act 178 SLH 2009, subject to any limitations as set forth in HRS § 235-110.9 as amended by Act 178 SLH 2009, for QHTB investments made on or after May 1, 2009.

This ruling is applicable only to the Company, its members and [redacted text] and shall not be applied retroactively. It may not be used or cited as precedent by any other taxpayer, and is based on our understanding of the facts that you have represented. If it is later determined that our understanding of these facts is not correct, the facts are incomplete, or the facts later change in any material respect, the conclusion in this letter will be modified accordingly. This ruling also may be subject to change due to future amendments to laws, rules, or official Department positions.

[1] While an investor could sell or transfer his membership interest, the total number of units and the investor's pro rata interest within the class would remain the same.

If you have any further questions regarding this matter, please email me at mark.j.yee@hawaii.gov. Additional information on Hawaii's taxes is available at the Department's website at **www.state.hi.us/tax**.

Very truly yours,

s/ Mark J.C. Yee

MARK J.C. YEE
Administrative Rules Specialist