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LETTER RULING NO. 2010-34

December 30, 2010

[REDACTED TEXT]
[REDACTED TEXT]
[REDACTED TEXT]
[REDACTED TEXT]

RE: APPLICATION OF CERTAIN TAX INCENTIVES TO [REDACTED TEXT]

Dear [REDACTED TEXT]:

This letter responds to your request of [REDACTED TEXT] for a comfort ruling confirming that certain tax incentives are available if [REDACTED TEXT] (the "Company") meets the definition of a qualified high technology business ("QHTB").

In general, Hawaii offers the following tax incentives to qualifying businesses:

1. The high technology business investment tax credit under § 235-110.9, Hawaii Revised Statutes ("HRS");

2. The income tax exclusion for royalties and other income derived from patents and copyrights received by an individual or a QHTB and developed and arising out of a QHTB under § 235-7.3, HRS; and

3. The income tax exclusion for stock options, dividends from stock, the receipt of the options, the exercise of the options, and income from the sale of the options under § 235-9.5, HRS.

In addition, other tax provisions may provide tax incentives to a QHTB that do not depend on whether the business meets the definition of a qualified high technology business.

SHORT ANSWER

Based on the information in your request for a high tech comfort ruling, the questionnaire, "Does a Company Qualify for Hawaii Tax Incentives?" ("Questionnaire"), and the representations made by the Company as stated below in this letter (the "Representations"), the Company will meet the definition of a qualified high technology business as defined in both § 235-7.3, HRS and § 235-110.9, HRS; provided the amount of cash invested in the Company does not exceed $5,000,000.

Based solely on the Representations, the Company qualifies as a QHTB for purposes of the tax benefits identified above in Paragraph 1.

Based solely on the Representations, the patents, copyrights, or trade secrets developed and arising out of the Company will qualify for the tax benefits identified above in Paragraph 2.

Based solely on the Representations, the Company's members will qualify for the tax benefits identified above in Paragraph 3, as further discussed in Part III of this letter.

FACTS REPRESENTED BY THE COMPANY

The Company makes the following representations:

The Company was formed for the purpose of, among other things, operating as an entertainment company conducting activities that constitute performing arts products. The Company's performing arts products are intended to relate primarily to the music industry; however the Company is presently exploring other performing arts product opportunities that include audio/visual, digital media, and motion picture and television film exploitations.

Record Label Activities

With respect to the production of performing arts products, the Company will engage in all aspects of performing arts products creation in the general capacity of a record label. Activities associated with record label production activities include talent and artist scouting, music arranging, music writing and composition, track production, recording and mastering, promotion of performing arts products, among other activities directly related to the creation and sales of performing arts products.

The Company's performing arts product production will occur primarily at two locations: 1) the Company's recording studio located at [REDACTED TEXT]; and 2) offsite production of live performances occurring elsewhere than [REDACTED TEXT], where the Company will be involved.

With respect to the recording of live performances at locations in Hawaii other than [REDACTED TEXT], the Company will not be involved in the business of producing the live performances themselves which, without more, do not constitute performing arts products. Rather, the Company will produce recordings, including all technical and artistic aspects thereof, but not the live performance event itself, the latter of which will be produced by others independent of the creation of recordings. For example, the Company is presently negotiating an arrangement with a third party that will operate a live music performance venue in Hawaii with a concert promoter. Under this arrangement, the concert promoter would engage the services of the Company to create recordings derived from the performances arranged and "put on" by the concert promoter. The concert promoter would either pay the Company a negotiated fee or provide other valuable consideration to the Company for the Company to perform its recording

services or, alternatively, the Company would pay license fees to the concert promoter and/or the talent for the privilege of recording the concerts. The amount paid for the license fee by the Company to the concert promoter will be the fair market value of the right to record the live performance, which is independent of the cost of putting on the live performance. The cost of putting on the live performances does not qualify as "qualified research." In either case, the Company will be entering into various contracts for the right to record and reproduce these live performances as part of the Company's business activities.

Music Studio Activities

The Company's record label and production company activities include the Company's operation and management of a recording studio. The recording studio will be used by the Company in furtherance of its own performing arts product production. Furthermore, the Company intends to offer the recording studio and its associated facilities to third-parties for use by the third-parties where the Company will not substantially and materially participate in the resulting performing arts products.

As part of the recording studio, the Company seeks to [REDACTED TEXT].

Other Entertainment Company Activities

In addition to the development, creation, and production of music-related performing arts products, the Company will also be involved in activity involving the development and production of other types of performing arts products, such as motion picture and television film production activity and digital media production activity. Examples of specific activity that directly relate to the development and production of other performing arts products include: locating, evaluating, optioning, licensing, and/or acquiring content for development into performing arts products; the selection and "marrying" of artists, producers, directors, writers, arrangers, composers and other talent; artist development; and the development and production (including co-production activity) of various types of other performing arts products.

As an entertainment company, the Company's business model also includes the Company entering into ventures with other non-performing arts product companies, where the Company is remunerated with the non-performing arts product companies' equity (versus cash). Such ventures would include arrangements whereby the Company would create performing arts products in association with the non-performing arts product company's products or services. For example, the Company has entered into active negotiations with a [REDACTED TEXT] that is in need of brand development. The Company and [REDACTED TEXT] have discussed an arrangement where the Company would create performing arts products and provide performing arts products services in association with [REDACTED TEXT] brand (through means of live recorded performances; jingles; or other use of [REDACTED TEXT] brand in relation to performing arts products) and [REDACTED TEXT] will pay for the Company's services through equity in [REDACTED TEXT].

In addition to the [REDACTED TEXT] venture, the Company represents that it has recently entered into [REDACTED TEXT] Production Services Agreements with third party clients. One agreement calls for the Company to develop, create, produce, mix, and master [REDACTED TEXT]. Under the terms of the second agreement, the Company will develop, create, and produce [REDACTED TEXT].

The Company is further considering expanding its technical production capabilities to include [REDACTED TEXT].

Marketing Activities

As part of its overall entertainment company business model, the Company finds it necessary to engage in various levels of promoting or marketing of its performing arts product services, as well as its performing arts products, occurring at different points in the lifecycle of a performing arts product. In its record label capacity, the Company will promote the Company's services to potential talent and other industry participants prior to production of performing arts products in order to sign artists whose content will be recorded by the Company. After performing arts products are produced, the Company will also market the completed product for sale or license to third parties. Further, with the Company's operation of its recording studio, the Company will, on occasion, market the studio's availability for use by third parties entirely for private third party use.

Time Method of Accounting

The Company represents that its qualified research activities involving performing arts products will constitute more than 50% of its total activities, as required by HRS § 235-110.9, as determined by the time spent on qualified research. The Company further represents that the time method of accounting is a reasonable method in this case.

Under the time method, the Company represents that it will satisfy the Activity Test based upon the ratio of the amount of time spent by the Company's employees on qualified activities related to the creation of the Company's performing arts products to the total amount of time spent by the Company's employees on all activities. Under the time method, only time spent by the Company employees are included in the calculation and time spent by third party contractors is properly excluded from both components of the time method ratio.

Moreover, the Company represents that a material component of its entertainment company business model is the operation and use of the recording studio. For purposes of satisfying the Activity Test, the Company will treat the studio as a timekeeping entity similar to that of an employee of the Company. As a timekeeping entity, the studio use must be quantified and calculated to account for qualified time spent toward creation of the Company's performing arts products and disqualified time that does not constitute qualified research, as discussed in more detail below at Part I.B. To that end, the Company shall consider the studio as a separate timekeeping entity by accounting for 2,000 hours per year of the studio's time. Of the 2,000 hours, each hour will either be qualified research time or disqualified time. 2,000 hours of

accounted studio time is arrived at by taking a 40 hour work week, where the studio is available for use, multiplied by 50 weeks in a year, which allows for approximately 2 weeks of ordinary industry closures for holidays, etc. The Company will be allowed to aggregate qualified time in the studio at any point in the year and not by any rigid time standards (*e.g.*, the Company may account for qualified time over a series of days during active recording sessions of its performing arts products, or in the middle of the night, rather than simply 9am-5pm, Monday through Friday). Thus, it is conceivable for the studio to be booked for several days or series of hours occurring at any point in the year.

From an operational standpoint, more than 50% of the Company's business activities will involve the creation of performing arts products that will be commercially exploited through sale, lease, or license. The performing arts products will be made either on behalf of the Company or on behalf of third parties who contract for the Company's services of which the Company is a substantial and material participant, and more than 75% of this activity will be conducted in Hawaii.

With respect to performing arts products created by the Company on the Company's own behalf, the Company will be deemed to be the "author" of the products and will license or assign its copyright rights therein to third parties so the works can be commercially exploited. With respect to performing arts products created by the Company on behalf of a third party, the Company will substantially and materially participate in the creation of third party performing arts products as a "work-for-hire" on behalf of the third party and/or the Company will assign to the third party the Company's copyright rights therein.

The Company has made additional representations, in Exhibit A, regarding jobs to be created by the Company, Hawaii costs, and investments in the Company.

LAW AND ANALYSIS

The requirements for these tax incentives and their application to the Company are discussed below.

I. High technology business investment tax credit

For investments made in taxable years beginning after December 31, 2000, but before taxable years beginning after December 31, 2010, a nonrefundable high technology business investment tax credit of up to $2,000,000 per taxpayer is available.[1] The credit is graduated over five years (35% to 10%) from the date of the "investment"[2] in a QHTB. The credit is capped at

[1] Taxpayers may continue to claim the credit in taxable years beginning after December 31, 2010 if the five-year period to claim the credit commences in taxable years beginning before January 1, 2011.

[2] "Investment" is defined as "a nonrefundable investment, at risk, as that term is used in section 465 (with respect to deductions limited to amount at risk) of the Internal Revenue Code, in a qualified high technology business, of cash that is transferred to the qualified high technology business, the transfer of which is in connection

varying amounts ($700,000 in the year the investment is made to $200,000 in the last year). Some of the credit claimed will be recaptured in certain circumstances.

Act 178 SLH 2009 added additional restrictions for investments received on or after May 1, 2009, 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;

- 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;

- 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; and

- IRC § 704(b)(2) is operative for partnership allocations of the High Technology Business Investment Tax ("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).

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.

Some of the credits claimed will be recaptured from the investor if at the close of any taxable year in the five-year period: (1) the Company no longer qualifies as a QHTB, (2) the

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with a transaction in exchange for stock, interests in partnerships, joint ventures, or other entities, licenses (exclusive or nonexclusive), rights to use technology, marketing rights, warrants, options, or any items similar to those included in this definition, including but not limited to options or rights to acquire any of the items included in this definition. The nonrefundable investment is entirely at risk of loss where repayment depends upon the success of the qualified high technology business. If the money invested is to be repaid to the taxpayer, no repayment except for dividends or interest shall be made for at least one year from the date the investment is made. The annual amount of any dividend and interest payment to the taxpayer shall not exceed twelve per cent of the amount of the investment." *See* § 235-1, HRS.

Company or an interest in the Company is sold by the taxpayer investing in the QHTB, or (3) the taxpayer withdraws the taxpayer's investment wholly or partially from the QHTB.

The recapture will be equal to ten percent of the amount of the total tax credit claimed for the investment in the two taxable years prior to the year in which any of the aforementioned events occurs. The recaptured amount must be added to the investor's tax liability for the taxable year in which the recapture occurs.

If a QHTB accepts any investments after June 30, 2007, the QHTB is required to file an annual survey as described in Act 206 (Session Laws of Hawaii, 2007). Failure to file the survey when due may result in a penalty of $1,000 per month for each month the annual survey is not filed, not to exceed a total of $6,000 for any annual survey not filed. Furthermore, by accepting an investment for which an investment credit allowed under section 235-110.9, HRS may be claimed, the QHTB is deemed by statute to have consented to the public disclosure of the Company's name and status as a beneficiary of the investment credit.

To be considered a QHTB for purposes of this tax credit, in each of the years for which the credit will be claimed, the Company must employ or own capital or property, or maintain an office, in Hawaii and:

(1) More than 50% of its total business activities must be qualified research and more than 75% of its qualified research must be conducted in Hawaii (the "Activity Test"); or

(2) More than 75% of its gross income must be derived from qualified research and the income from this qualified research must be received from:

(a) Products sold from, manufactured in, or produced in Hawaii; or

(b) Services performed in Hawaii (the "Gross Income Test").[3]

If the Company contracts with another person to perform qualified research, the research will qualify as research performed by the Company for the purpose of determining the Company's status as a QHTB only if the contract meets the following requirements:

(1) The contract must be entered into before the performance of the qualified research activity;

(2) The contract requires the Company to bear the expense of the research even if the project is unsuccessful;

[3] This definition of a QHTB for purposes of § 235-110.9 differs from the definition of a QHTB in § 235-7.3, HRS, which is discussed in Part II of this letter.

(3) The contract provides that the research is to be performed on behalf of the Company and the Company will have substantial rights to the research results[4]; and

(4) The contract provides that the company performing the research will not claim the Hawaii qualified high technology business investment credit under HRS §235-110.9 or the Hawaii tax credit for research activities under HRS §235-110.91 for the activities performed on behalf of the Company.

If another person contracts with the Company to have the Company perform qualified research, the research will not qualify as research performed by the Company for the purpose of determining the Company's status as a QHTB if the above requirements have been met in favor of the other person, even if the other person is not a QHTB.

The Department has also released Tax Information Release 2008-07 (High Tech Comfort Rulings Relying on the Gross Income Test), which is incorporated by reference herein.

A. The Company's presence in Hawaii

The Company, a [REDACTED TEXT] organized under the laws of [REDACTED TEXT], represents that it maintains its office in Honolulu, Hawaii. Therefore, for purposes of § 235-110.9, HRS, the Company meets the requirement that it employ or own capital or property or maintain an office in Hawaii.

B. The Company's qualified research activities

The term "qualified research" means:[5]

(1) The same as in § 41(d), Internal Revenue Code ("IRC");

(2) The development and design of certain computer software;

(3) Biotechnology;

(4) Performing arts products;

(5) Sensor and optic technologies;

[4] If the Company receives a license, the term of the license must be for the useful life of product(s) or research.

[5] Section 235-110.9, HRS, incorporates the definition of "qualified research" in § 235-7.3, HRS.

(6) Ocean sciences;

(7) Astronomy; or

(8) Nonfossil fuel energy-related technology.

Item (4) Performing arts products

Item (4) of the definition of "qualified research" includes performing arts products. Performing arts products is defined as:

(1) Audiofiles, video files, audiovideo files, computer animation, and other entertainment products perceived by or through the operation of a computer; and

(2) Commercial television and film products for sale or license, and reuse or residual fee payments from these products.

Representations in the Questionnaire

In Part I of the Questionnaire, the Company checked the box indicating that it is involved in performing arts products. By checking this box, the Company represents that it meets the requirements of Item (4) of qualified research. The statute does not contain a verb defining qualified research activities in the context of performing arts products. Nevertheless, it is the Department's position that qualified research necessarily implies a QHTB's creation of a performing arts product of the QHTB. In accordance with this interpretation, all activities of a QHTB that contribute substantially and materially to the creation of a performing arts product of the QHTB are considered qualified research within the meaning of HRS § 235-7.3.

Direct Creation of Performing Arts Products

With respect to performing arts products created by the Company on the Company's own behalf, the Company will be deemed to be the "author" of the products and will license or assign its copyright rights therein to third parties so the works can be commercially exploited. With respect to performing arts products created by the Company on behalf of a third party, the Company will substantially and materially participate in the creation of third party performing arts products as a "work-for-hire" on behalf of the third party and/or the Company will assign to the third party the Company's copyright rights therein. Creation of performing arts products on the Company's own behalf shall constitute qualified research. Creation of performing arts products on behalf of a third party constitutes qualified research only to the extent the Company's participation is substantial and material.

Insubstantial or immaterial contribution to a performing arts product of a third party shall be considered disqualified activity. Substantiality and materiality may be determined by any number of industry-standard means, including the Company receiving a credit for participating

in the creation of the performing arts product; the Company obtaining a profit participation or other stream of revenue derived from the product; or the amount of copyrightable subject matter either inuring to the Company or being transferred from the Company to the third party, depending upon the amount of the Company's rights when compared to the work as a whole.

Passive Activities & Studio Use

Any activities that are considered passive activities related to the operation or use of the recording studio do not constitute qualified research and are therefore disqualified time. Passive activities include studio operations that are not in furtherance of the performing arts products of which the QHTB is a substantial and material participant. Passive activity for purposes of this ruling specifically includes the renting of the studio to a third-party, without more. Under this ruling, merely serving as a landlord and charging rents to third parties utilizing the studio does not constitute qualified research. Similarly, any gross income derived from the leasing or renting the studio to a third party, without more, would not constitute gross income from qualified research and would therefore not satisfy the Gross Income Test. Idle time, where the studio is vacant, is also not qualified research and is disqualified time.

As discussed above, the Company will treat the studio as a timekeeping entity similar to that of an employee of the Company. As a timekeeping entity, the studio use must be quantified and calculated to account for qualified time spent toward creation of the Company's performing arts products and disqualified time that does not constitute qualified research. To that end, the Company shall consider the studio as a separate timekeeping entity by accounting for 2,000 hours per year of the studio's time. Of the 2,000 hours, each hour will either be qualified research time or disqualified time. Qualified research time includes time using the studio by the Company in the creation of the Company's performing arts products or performing arts products of a third party, the creation of which the Company substantially and materially participates. Disqualified time includes the passive activities discussed in this section, namely the renting of the studio to third parties, without more, as well as time where the studio sits idle.

In its calculation of the time method, at least 2,000 hours of studio time must be included in the denominator of the Activity Test, which is discussed in more detail below at Part I.C., which includes examples.

Promoting & Marketing

The Company has represented that, as a matter of necessity, as well as industry practice, it will spend time promoting the Company's record label services to talent and other industry persons in order to attract artists. The Company will also spend time marketing and promoting the completed performing arts products, as well as the availability of the studio for third party use.

Qualified research within the meaning of HRS § 235-7.3 is considered in light of industry standard. However, "research" ceases once the product or project is complete because there is no longer any activity constituting research once the project is completed. The conclusion that

research ceases once the product or project is completed is consistent with the Department's position that qualified research means the "creation" of performing arts products.

Because qualified research activities means the creation of the product or project, promotion or marketing as qualified research activities must be bifurcated between pre- and post-completion. As such, the Company's promoting time expended in order to obtain talent and artists is necessary as a matter of industry practice. The Company must dedicate time to promoting its label to attract artists to sign in order to record their content. Because the Company must scout for talent and obtain artists to create performing arts products, such pre-completed performing arts product promoting will be considered qualified research (the Department likens promoting the label to attract artists to a motion picture production company's scouting for locations or casting a movie, which undoubtedly qualify as research activities). However, once the product or project is completed, promotion or marketing will be disqualified activity because there is no longer "research" being conducted or performing arts products created. Furthermore, promoting or marketing the recording studio's use to third parties, without substantial and material participation of the Company involved with third party use, is likewise disqualified because such activity does not lead to the creation of the Company's performing arts products.

C. Activity Test and Gross Income Test

Under § 235-110.9, HRS, in order for a company performing qualified research to meet the definition of a QHTB, it must be a business employing or owning capital or property, or maintaining an office, in the State of Hawaii. In addition, the company must meet the requirements of either the Activity Test or the Gross Income Test. Under the Activity Test, a company is a QHTB if more than 50% of its total business activities are qualified research and more than 75% of such qualified research is conducted in Hawaii. Under the Gross Income Test, a company is a QHTB if more than 75% of its gross income is derived from qualified research in the form of either (i) products sold from, manufactured in, or produced in Hawaii, or (ii) services performed in Hawaii.

Due to the highly fact intensive nature of qualifying as a QHTB under the Gross Income Test, including the uncertainty and ambiguity of: 1) revenue streams associated with qualified research; 2) determining the source of product sales; 3) manufacturing or production quantification; as well as 4) the extent services are performed in the State within the meaning of HRS § 235-110.9(g), the Department will not issue rulings determining whether a business satisfies the Gross Income Test for purposes of qualifying as a QHTB.

The Company represents that it will meet the Activity Test because more than 50% of its activities will be in qualified research and more than 75% of those qualified research activities will be conducted in Hawaii. In making this determination, the Company used a numerator that contained the time spent on activities in direct support of qualified research and a denominator that included all time for all activities of the Company, including any disqualified time discussed

above, as well as at least 2,000 hours taking into account the studio as a timekeeping entity.[6] Furthermore, as to the requirement that 75% of the qualified research activities be conducted in Hawaii, the Company used a numerator that contained all time spent in direct support of qualified research activities conducted in Hawaii and a denominator that contained all time spent for all qualified research activities. In making these representations about the Activity Test, the Company understands that the following activities do not count as qualified research activities for purposes of this test:

- Activities associated with research that is funded by grants and in which the Company has no substantial risks and rights;
- Activities associated with research being performed by the Company pursuant to a contract in which the contract requirements discussed in Part I, above, have been met in favor of another party to the contract;
- Activities performed by another business on behalf of the Company where the contract requirements discussed in Part I, above, have not been met in favor of the Company; and
- Activities determined to be disqualified activities discussed above (including participation in the creation of performing arts products of which the Company does not materially participate; third party or idle use of the studio; and certain marketing activities).

In the analysis of the Activity Test, the treatment of the studio as a timekeeping entity is demonstrated by the following examples—

Example 1

Assume the Company has two full time 40-hour-per-week employees (2,000 hours of total activity each), in addition to the studio, totaling 6,000 hours in Company time in the aggregate. To satisfy the Activity Test, the Company must aggregate all of its qualified research time and its time spent on all activities, including disqualified activities. Assume that both employees work entirely on qualified research and the studio is used for 1,000 hours on qualified research. The two employees account for 4,000 hours of qualified research time. The studio accounts for only 1,000 of qualified research; however 2,000 hours must still be accounted for in the denominator. Aggregating these amounts, the Company has 5,000 of qualified research time (*i.e.*, 2,000 hours for each employee and 1,000 hours for the studio), over a total of 6,000 hours of aggregate Company time. Under this example, the Company has approximately 83% in qualified research, which satisfies the Activity Test.

[6] "Business activities" may be measured by the cost of these activities, the time spent on these activities, or another consistently applied reasonable basis. The taxpayer has elected to have its activities tested based upon the time method discussed herein.

Example 2

Assume the same facts as in the prior paragraph, except that Employee A has only 500 hours of qualified research activity out of 2,000 total hours working full time. Employee B has all 2,000 hours of working full time on qualified research. Lastly, the studio has the same 1,000 hours of qualified time. The Company will still satisfy the Activity Test because the aggregated time exceeds 50% of total time. Aggregating these amounts, the Company has 3,500 hours of qualified research time (*i.e.*, 500 hours for Employee A; 2,000 for Employee B; and 1,000 hours for the studio), over a total of 6,000 hours of aggregate Company time. Under this example, the Company has approximately 58% in qualified research, which satisfies the Activity Test.

Example 3

Assume the same facts as in the prior paragraph, except that the studio sits idle the entire year, which results in zero qualified time. Because the Company is required to account for 2,000 hours of studio time as a timekeeping entity, it must continue to include 2,000 hours in the denominator. As such, the Company will fail the Activity Test because the aggregated time does not exceed 50% of total time. Aggregating these amounts, the Company has 2,500 hours of qualified research (*i.e.*, 500 hours for Employee A; 2,000 for Employee B; and 0 hours for the studio) over a total of 6,000 hours of aggregate Company time. Under this example, the Company has approximately 42% in qualified research, which does not satisfy the Activity Test.

Based on the Representations, the Company is a QHTB for purposes of the high technology business investment tax credit because it meets the requirements of Item (4) in the definition of "qualified research," the Company will maintain an office in Hawaii, and the Company satisfies the Activity Test as discussed above. Solely based on the Representations, investments (as defined in HRS § 235-1) in the Company will qualify for the high technology business investment tax credit.

D. Substantiation

Due to the qualifying and non-qualifying conclusions related to activities drawn in this letter, the substantiation of the Company's activities in order to ensure that it maintains its QHTB status is crucial. The Company must maintain reliable, written substantiation of the Company's activity in any reasonable form, such as time logs or timesheets. The written substantiation of the Company's activities may be requested by the Department for the Department's review.

E. Credit Recapture

Section 235-110.9(d), HRS, provides for recapture of credits that have been claimed by a taxpayer where one of the following three events occurs (recapture event):

(1) The business no longer qualifies as a QHTB;
(2) The business or an interest in the business has been sold by the taxpayer investing in the QHTB;
(3) The taxpayer has withdrawn the taxpayer's investment wholly or partially

from the QHTB.

Where recapture is triggered, 10% of the amount of the total tax credit claimed by the selling or withdrawing investor in each of the two taxable years prior to the year in which recapture occurs must be added to such investors' tax liability for the taxable year in which the recapture occurs.

The credit cannot be claimed in the year of a recapture event because investors do not have an investment in a QHTB. If a recapture event occurs, the Company should notify the investors that they are not eligible to claim the credit and that some of the credit claimed in prior years shall be recaptured.

F. Credit Allocation

For investments made on or after May 1, 2009, allocations, special or otherwise, of credits may not exceed the amount of the investment made by the taxpayer ultimately claiming this credit; and investment tax credit allocation ratios greater than one dollar of credit for every dollar invested shall not be allowed.

II. Income tax exclusion for royalties and other income from QHTB

Pursuant to § 235-7.3, HRS, an income tax exclusion is available for income received by an individual or a QHTB[7] as royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of a QHTB.[8] The exclusion may be claimed by the individual or QHTB that owns the patents, copyrights, or trade secrets. For purposes of the royalty income exclusion, a QHTB is defined as "a business conducting more than 50% of its activities in qualified research."[9]

As discussed in Part I, relating to the high technology business investment tax credit, the Company's representations meet the requirements of Item (4) in the definition of "qualified research." The Company also represents that more than 50% of the Company's activities are in qualified research, again using a numerator that contained the time associated with qualified research activities and a denominator that included all time for all activities. Based on the Representations, royalties and other income derived from any patents, copyrights, and trade

[7] If the QHTB receiving the income is treated as a partnership for income tax purposes, then the partners or members of the QHTB may exclude the allocated portion of such income, even if the partner or member excluding the income is not an individual or QHTB.

[8] Expenses for royalties and other income derived from any patents, copyrights, and trade secrets by an individual or a QHTB as defined in § 235-7.3, HRS, are deductible. *See* § 235-2.4(g), HRS.

[9] This definition differs from the definition of a QHTB in § 235-110.9, HRS, which is discussed in Part I of this letter.

secrets developed and arising out of the Company received by an individual[10] or a QHTB may be excluded from income tax. Furthermore, as long as the Company is a QHTB for purposes of § 235-7.3, HRS and treated as a partnership for income tax purposes, each member's allocated portion of royalties and other income derived from patents, copyrights, and trade secrets owned by the Company and developed and arising out of a QHTB may be excluded from income tax by the members of the Company.

III. Income tax exclusion for stock options from qualified high technology business

Section 235-9.5, HRS, provides an exclusion for "all income earned and proceeds derived from stock options or stock," including stock issued through the exercise of stock options or warrants, from a QHTB or from a holding company of a QHTB[11] by an employee, officer, or director of the QHTB, or investor who qualifies for the high technology business investment tax credit in § 235-110.9, HRS, effective for taxable years beginning after December 31, 2000. This exclusion is applicable to dividends from stock or stock received through the exercise of stock options or warrants, the receipt or the exercise of stock options or warrants, and income from the sale of stock, including stock issued through the exercise of stock options or warrants.[12]

With respect to a partnership or a limited liability company treated as a partnership for income tax purposes, the exclusion is applicable only to the gain from the sale of membership interest units. For purposes of this income tax exclusion, a QHTB means the same as defined in §235-7.3, HRS, relating to the income tax exclusion for royalties.

As discussed in Part I, relating to the high technology business investment tax credit, the Company's representations meet the requirements of Item (4) in the definition of "qualified research." The Company also represents that more than 50% of the Company's activities are in qualified research, again using a numerator that contained the time associated with qualified research activities and a denominator that included all time for all activities. Based on the Representations and assuming the Company is treated as a corporation for income tax purposes, the income earned and proceeds derived from stock options, stock, options to acquire an equity interest, or equity interests may be excluded from income tax. However, if the Company is treated as a partnership for income tax purposes, only the gain from the sale of membership

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[10] The performing arts product exclusion in § 235-7.3, HRS, is applicable to the author and assignors, licensors, and licensees.

[11] A holding company of a QHTB means any business entity that possesses:

(1) At least eighty per cent of the total voting power of the stock or other interest; and

(2) At least eighty per cent of the total value of the stock or other interest in the qualified high technology business.

[12] Section 165, IRC, is operative for Hawaii income tax purposes and applies to losses sustained from the sale of stock issued through stock options or warrants granted by a QHTB. *See* § 235-2.4(d), HRS.

interest units may be excluded from income tax. And if the Company is treated as a sole proprietorship because it is a single-member limited liability company, then § 235-9.5, HRS, is not applicable.

IV. Conclusion

Based solely on the Representations, the Company qualifies for:

1. The high technology business investment tax credit under §235-110.9, HRS;

2. The income tax exclusion for royalties and other income derived from patents, copyrights and trade secrets received by an individual or a QHTB and developed and arising out of a QHTB under §235-7.3, HRS; and

3. If the Company is taxed as a corporation, the income tax exclusion for income earned and proceeds derived from stock options or stock, including income from dividends from stock or stock received through the exercise of stock options or warrants, the receipt or exercise of stock options or warrants, and the sale of stock options or stock, including stock issued through the exercise of stock options or warrants, under §235-9.5, HRS is applicable. If the Company is treated as a partnership for income tax purposes, the section 235-9.5, HRS exclusion is applicable only to the gain from the sale of membership units. If the Company is treated as a sole-proprietorship because it is a single-member limited liability company, then § 235-9.5, HRS, is not applicable.

This ruling is applicable only to the Company, 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, and only applies if the amount of cash investments received by the Company does not exceed $5,000,000. In the event that the Company finds it necessary to increase the amount of investment monies to be obtained which qualifies for the high technology business investment tax credit, the Company shall submit a supplemental ruling request to the Department. No user fee shall be assessed on such supplemental ruling request.

HRS § 235-110.9(k) provides that the high technology business investment tax credit does not apply to taxable years beginning after December 31, 2010. All investments must conform to this provision to be eligible for the investment credit.

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.

The Company has reviewed and agreed that the redacted version of this ruling attached as Exhibit B will be available for public inspection and copying.

If you have any further questions regarding this matter, please call me at 808-587-1569. Additional information on Hawaii's taxes is available at the Department's website at www.state.hi.us/tax.

Very truly yours,

JOSEPH B. TICHY
Administrative Rules Specialist

APPROVED BY:

JOHNNEL NAKAMURA
Rules Officer

[REDACTED TEXT]