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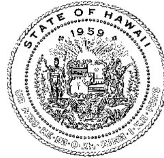

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

March 17, 2003

TAX INFORMATION RELEASE No. 2003-1

RE: Application of Section 235-110.9, Hawaii Revised Statutes (HRS), relating to the High Technology Business Investment Credit

I. Introduction

This Tax Information Release (TIR) explains the proper application of the law regarding the high technology business investment tax credit.

While the purpose of Act 221, Session Laws of Hawaii 2001 (Act 221), and the high technology business investment credit was to stimulate investment in Hawaii high technology businesses and certain performing arts businesses, and expand venture capital market financing for such businesses, certain taxpayers may be engaged in potentially abusive transactions involving the high technology business investment credit. Among the type of transactions that **do not** qualify for the high technology business investment credit are: (1) investments that lack economic substance or a business purpose; (2) related party transactions that minimize the amount of actual investment or "new money," and (3) certain restructuring and reorganizations that lack economic substance or a business purpose.

To identify and challenge such potentially abusive transactions, the Department will be:

- Developing and implementing an audit program intended to target abusive claims of the high technology business investment credit;
- Requiring additional information from taxpayers seeking rulings or claiming the high technology business investment credit on tax returns; e.g., the total number of jobs and the number of new jobs created or to be created; whether these jobs are permanent or temporary; the average salaries of the jobs created or to be created; whether the salaries or compensation involve or contemplate property such as stock options and a description of the compensation; the costs and expenditures incurred in Hawaii such as employee costs, rental or purchase of property and payments to Hawaii independent contractors; a description of the taxpayer's long term business plan in Hawaii and benefits to the Hawaii economy; tax incentives expected to be claimed; and the total amount of investments received by the qualified high technology business (QHTB); and
- Promulgating rules clarifying the application of HRS §235-110.9.

This TIR provides interim guidance, including a discussion of certain common law doctrines ("economic substance" and "business purpose") which may be raised against abusive transactions. This TIR shall not be construed as altering or supplanting any other common law doctrine (including the "sham transaction" doctrine), and shall be construed as being in addition to any other doctrine.

II. High technology business investment tax credit, in general

A nonrefundable high technology business investment tax credit of up to $2,000,000 is available for each taxpayer that is subject to Hawaii income tax for an investment in a QHTB.[1] A credit is allowable for each year during a five-year period and declines from 35% to 10% from the date of the "investment" for investments made through the year 2005. The credit is capped at varying amounts ($700,000 in the year the investment is made to $200,000 in the last year). Ten percent (10%) of the credit claimed in the two preceding taxable years will be recaptured from the taxpayer if the QHTB ceases to qualify as a QHTB during the five-year period, otherwise the aggregate credit over the five-year period will equal 100% of the taxpayer's qualified investment.

III. Special allocation of the high technology business investment tax credit; safe harbor

An "investment"[2] must be made in the QHTB to generate a high technology business investment credit. An investment will only be respected if the taxpayer has a reasonable expectation of (1) a return of capital and (2) a reasonable return on capital at the time the investment is made.

Act 221, among other things, allows partnership investors the flexibility of allocating the high technology business investment tax credit among the partners without regard to the substantial economic effect tax rule of Section 704(b)(2) of the Internal Revenue Code of 1986,

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[1] The credit is also available to taxpayers subject to the Hawaii franchise tax or gross premiums tax. HRS §241-4.8; HRS §431:7-209.

[2] Section §235-1, HRS, the term "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 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 payments to the taxpayer shall not exceed twelve percent of the amount of the investment. (Emphasis added.)

as amended (26 U.S.C. 704) ("IRC"). While HRS §235-2.45(e)(1) provides that partners may allocate the credit without regard to the substantial economic effect rule, transactions that lack economic substance or a business purpose are subject to the guidelines in this TIR.

In the future, the Department plans to provide further guidance regarding a "safe harbor" in another TIR or rules. This safe harbor will be applied prospectively to investments made after the effective date of the next TIR or rules.

IV. Certain restructuring and reorganizations and related party transactions

Certain restructuring and reorganizations and related parties transactions will be closely scrutinized by the Department due to the potential for manipulation and abuse of the legislature's intent in enacting Act 221. There is no safe harbor test and these types of transactions must have economic substance and a business purpose.

Example 1. A invests $1 million in X, a QHTB. A receives all of the stock of X in exchange for the investment. A and X are related parties because A owns a controlling interest in X. Immediately after the investment, X contracts with A and pays A $800,000 to perform qualified research.

For purposes of Act 221, it will be presumed that these steps are integrated and that the integrated transaction lacks economic substance and a valid business purpose.

Example 2. X transfers its research department and cash to a wholly owned entity Y to perform qualified research. X claims high technology tax credits for its investment in Y. For purposes of Act 221, it will be presumed that these steps are integrated (even if the cash is transferred prior or subsequent to the transfer of the research department) and that the integrated transaction lacks economic substance and a valid business purpose.

Among the factors that that the Department will consider in establishing economic substance and business purpose are the following: expenditures in Hawaii; expected long term benefits to Hawaii and its economy; new capital raised from third-parties by the entity; increased spending to accelerate research projects; new jobs created or maintained in Hawaii as a result of the transfer of the research department to a wholly owned new entity; and/or whether the new entity is performing research for sale or license to unrelated third parties.

V. Investments in Movie Businesses

The intent of Act 221 was to encourage continued growth and development of high technology businesses and associated industries in Hawaii. The Department will be developing and implementing an audit program to review investments made into QHTBs formed to produce a single movie to determine whether the QHTBs meet the "Activity test" or the "Gross income test" under HRS §235-110.9(e)(1) and (2) and are a business within the meaning of HRS §235-

110.9(e).[3] With respect to the "Activity test" the QHTB must actively produce the movie. With respect to the "Gross income test" the QHTB must receive income from the sale of the products of the QHTB. Income will not include:

- Predetermined payments structured over the five-year period that are not received from the sale of the products or services of the QHTB;
- Payments from amounts that were set aside for the specific purpose of being distributed to the QHTB as "income" in years two through five of the period during which the credit is claimed, for example, escrow accounts; and
- Any other insubstantial amount received by the QHTB in years two through five of the period during which the credit is claimed where the Department determines the payment is made for the purpose of qualifying for the credit or not having a credit recaptured.

Example 3. A and B form a limited liability company (MovieLLC) to produce movies in Hawaii. Movie LLC produces a movie and enters into a distribution agreement with DistributionCo. The terms of the agreement are negotiated at arms length and reflect industry practices. In years 2, 3, 4, and 5, MovieLLC will receive substantial income from DistributionCo under a contract that reflects standard industry practices.

MovieLLC will satisfy the income test.

Example 4. A limited liability company is formed (ProduceLLC) in Hawaii to produce the movie. Filmco, a mainland company, contributes $8 million dollars to ProduceLLC in year 1. Four Hawaii investors each contribute $750,000 to ProduceLLC or a total of $3 million. Filmco owns the majority of the equity of ProduceLLC. Filmco contracts with ProduceLLC to produce the movie. Filmco receives all the distribution rights to the movie. ProduceLLC receives a profits interest in the movie that is the greater of $50,000 a year or a percentage of the profits for years 2, 3, 4 and 5. At the closing, $200,000 is paid into an escrow account by Filmco to ensure that ProduceLLC receives $50,000 a year. At the time the contract was made, the parties knew that it was highly unlikely that ProduceLLC would receive payments in excess of $50,000. The agreement does not reflect industry standards and was not negotiated at arms length.

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[3] HRS §235-110.9(e) provides:

"Qualified high technology business" **means 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 qualified research; and provided further that the business conducts more than seventy-five per cent of its qualified research in this State ("the Activity test"); or

(2) More than seventy-five per cent of its gross income is derived from qualified research; 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 ("the Gross income test")."

(Emphasis added.)

ProduceLLC is not a QHTB because it does not satisfy the income test. The payments were not from the sale of products or services of the QHTB, were set aside for the specific purpose of being distributed to the QHTB as "income" from an escrow arrangement, and the payments were insubstantial. In fact, the $50,000 payments were from amounts set aside at closing, rather than from profits of the movie.

Example 5. Filmco intended to film and produce a movie on the Mainland. It changes its plans and forms a new limited liability company (ProduceLLC) to produce the movie in Hawaii. Filmco contributes $8 million dollars to ProduceLLC in year 1. Four Hawaii investors each contribute $750,000 to ProduceLLC for a total of $3 million. Filmco owns the majority of the equity of ProduceLLC. Under a contract with Produce LLC, Filmco or a related entity will produce the movie. Filmco or a related entity receives the distribution rights to the movie. ProduceLLC receives a profits interest in the movie that is the greater of $50,000 a year or a percentage of the profits for years 2, 3, 4 and 5. ProduceLLC does not retain any copyright to or any significant results of the film produced. Filmco or a related entity retains the copyright or the results of the research. The contract was not negotiated at arms length.

ProduceLLC is not a QHTB because it is not actively involved in the production of the movie; a QHTB's activities must be sufficiently substantial and regular to constitute a business within the meaning of HRS §235-110.9(e). The investment by Filmco and the Hawaii investors, therefore, does not qualify for the credit.

In this case, ProduceLLC functioned only as a vehicle for injecting capital into Filmco in a manner designed to attempt to qualify for the credit. Filmco is not a QHTB because it was only present in Hawaii to do the filming and it left Hawaii after filming was completed. ProduceLLC's activities never surpassed those of an investor. It did not create a business with long-term potential that Act 221 was intended to promote.

ProduceLLC effectively has no ownership interest in the movie. Filmco is distributing and marketing the movie. Filmco or a related entity performed all of the qualified research by filming the movie. Filmco or a related entity retained the results of the research by retaining the copyrights to the film.

ProduceLLC's interest in the production of the movie is analogous to that of an investor in securities. The only activity conducted by ProduceLLC was the management of an investment. The management of an investment does not rise to the level of a trade or business regardless of the extent of the investment or the time required to perform the managerial functions.[4]

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[4] Higgins v. Comr., 312 U.S. 212 (1941); Purvis v. Comr., 33 T.C.M. 702 (1974), aff'd per curiam, 530 F.2d 1332 (9th Cir. 1976).

VI. Common Law Doctrines

Economic Substance

The “economic substance” doctrine denies tax benefits in transactions that do not result in a meaningful change to the taxpayer’s economic position other than a purported reduction in tax.

The United States Tax Court has described the doctrine as follows:

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[5]

Whether a transaction has economic substance is a factual determination.[6] This determination turns on whether the transaction is rationally related to a useful nontax purpose of the taxpayer that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs.[7] Transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes.[8]

The Department will be reviewing transactions to determine if they have economic substance. Generally, a transaction will have economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes, or reasonably be expected to change, in a meaningful way (apart from State income tax consequences) the taxpayer’s economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.

The Department will be making an objective inquiry regarding the effects of the transaction on the taxpayer’s economic position, as well as a subjective inquiry regarding the

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[5] ACM Partnership v. Commissioner, T.C. Memo. 1997-115, aff'd in part and rev'd in part 157 F.3d 231 (3d Cir. 1998)

[6] United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 456 (1950).

[7] Yosha v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986).

[8] ACM Partnership v. Commissioner, 157 F.3d 231, 248 (3d Cir. 1998).

taxpayer's motives for engaging in the transaction. The transaction must satisfy both tests. It must change, or reasonably be expected to change, in a meaningful way (apart from State income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) in order to satisfy the economic substance requirement.

The transaction must result in a "change in a meaningful way" in the taxpayer's economic position or have a "substantial non-tax purpose." For example, it is intended that a "reasonable possibility of profit," when interpreted to mean a minimal amount of profit, would not be sufficient to establish that a transaction has economic substance.

Business Purpose

The business purpose doctrine requires that a taxpayer have a reason, other than the avoidance of taxes, for undertaking a transaction. The business purpose doctrine examines the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose.[9] A taxpayer's non-tax purpose for entering into a transaction must be "substantial," and the transaction must be "a reasonable means" of accomplishing such purpose.

In order to satisfy the business purpose test, the taxpayer must demonstrate that the transaction was not solely motivated by tax considerations and that a substantial non-tax purpose existed for the transaction. The substantial non-tax purpose for the transaction would have to bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[10]

A taxpayer's non-tax purpose for entering into a transaction must be "substantial," and the transaction must be a reasonable means of accomplishing such purpose.

VII. Effective Date

This TIR is effective immediately except that common law doctrines such as the economic substance and business purpose doctrines apply to any transaction claiming the high technology business investment credit.

This TIR will not be applied retroactively to taxpayers who have previously received a High Tech Comfort Ruling if (1) there has been no misstatement or omission of material facts,

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[9] ACM Partnership v. Commissioner, 157 F.3d at 256 n.48. (3d Cir. 1998).

[10] *See,* Martin McMahon Jr., Economic Substance, Purposive Activity, and Corporate Tax Shelters, 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators.").

(2) the facts subsequently developed are not materially different from the facts on which the ruling was based, and (3) the taxpayer involved in the ruling acted in good faith in reliance upon the ruling.

KURT KAWAFUCHI
Director of Taxation

HRS Section Explained: HRS §235-110.9
§235-1