Attachment 1

October 20, 2006

Mr. Isaac Choy
Chair, State of Hawaii Tax Review Commission
P.O. Box 259
Honolulu, HI 96809

Thank you for giving representatives from industry this opportunity to share our thoughts and provide input for your report on the Act 221/215 Investment Tax Credit. As advocates for Hawaii's burgeoning technology industry, we recognize our fiscal responsibility and fully agree on the need to effectively track and evaluate this incentive. However, based on the information presented by professors Marcia Sakai and Bruce Bird in their draft study, "Measuring the Costs and Benefits of Hawaii's Qualified High Technology Business (QHTB) Investment Tax Credit under Act 221 and Act 215", we believe it is unrealistic and premature to expect a meaningful and accurate indication of effectiveness based on static model computations and only two years of questionable data.

Evaluating the effectiveness of economic development incentives is something states across the nation are struggling with and it is not a standardized or clear-cut exercise. To reflect a true indication of the impact of the investment tax credit and generate constructive information to guide policy makers requires careful consideration of multiple factors including economic data, historical and regional context, and a clear understanding of the policy goals intended. With a better understanding of the intended objectives of the incentive, benchmarks can be identified by which the economic and fiscal data can best be evaluated.

Our greatest concern is that an incomplete study missing even these core elements will generate misleading interpretations and create unnecessary confusion and controversy. Distortions and inaccuracies can ultimately undermine the overall effect of the incentive and give policy makers unhelpful and possibly detrimental guidance.

We sense that there is a general misconception by some that industry does not want Act 221/215 evaluated. This is not correct. We agree that an analysis is needed and have dutifully complied with the numerous data collection requirements from the Tax Dept. Data from both QHTBs (Comfort Ruling Request and Form N-317) and investors claiming the credits (Certification and N-318A) have been provided to the Tax Dept. at additional expense (Tax Dept. fees and legal/accountant fees).

The central issue is not about a lack of data, but the two basic issues of:

- how the data is being managed, compiled, and disseminated
- how the data is being evaluated
- misreading of the policy intent behind the incentive.

The technology industry in Hawaii has experienced significant growth in a short time. The transformation is undeniable – from the expanding angel networks, to the numerous venture capital conferences, to the ever-increasing numbers of tech companies, to the growing numbers of kama'aina that were brought back home. The environment was very different in 1999. We agree that an empirical cost-benefit analysis is needed, but by itself, does not provide an adequate picture of effectiveness. It should begin with a clear understanding of the policy goals.

As many of us were personally and directly involved in the development, policy discussions, analysis and implementation of the credit over the last 7 years, we thought it might be beneficial to provide a review of the history and policy intentions underlying this incentive. As the study focused specifically on the Investment Tax Credit, we have limited our comments to this subject.

We hope this information is of value to your Commission members and we offer any assistance we can give. Please feel free to contact us should you have any questions or comments.

Mahalo,

Lisa Gibson (President)
Hawaii Science & Technology Council

Ann H. Chung (Vice-President)
Hawaii Science & Technology Council

Mike Fitzgerald (President)
Enterprise Honolulu

Bill Spencer (President)
Hawaii Venture Capital Association

Rob Robinson (Convener)
UH Angels

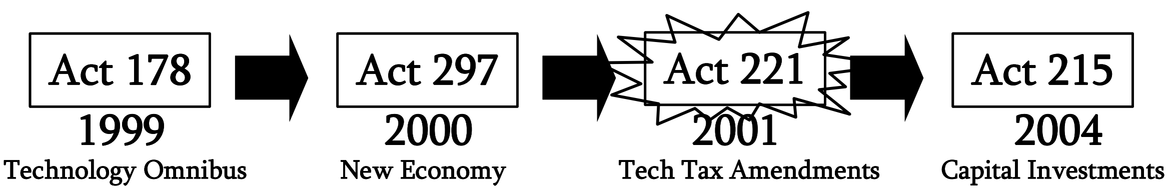
<u>Act 221/215 – Investment Tax Credit</u>
What was the INTENT behind this incentive?

Act 221/215 is the latest in a progression of legislative efforts to foster the growth of a technology industry in Hawaii. From an initial meager form, the investment tax credit as passed in Act 221/215 was dramatically increased providing an unprecedented incentive viewed globally as landmark legislation. Although many other states offered similar tax incentives to encourage their technology firms to expand, Hawaii's investment tax credit was and continues to be by far the most progressive in the nation. **To fully understand the policy intent driving this considerable initiative, the Acts that preceded it and the historical context at the time must be revisited.**

Although we will be limiting our comments to the Investment Tax Credit, it is important to recognize that each Act contained a number of initiatives intended to provide additional support to local tech companies relating to workforce development, venture capital, improvements to state tech-related agencies, education, infrastructure, funding, as well as other significant tax incentives such as the Research Tax Credit and exemption on Stock Options & Royalties.

<u>Before 1999</u>

The 1990's was one of the worst economic periods in Hawaii's history. Beginning with the Persian Gulf War, the burst of Japan's "Bubble" economy and the additional devastation of Hurricane Iniki, the State's economic slump continued for years. In the late 1990's, during the height of the Dot.Com Bubble, Hawaii sluggish economy remained flat. The decade of Brain Drain worsened with the increasing numbers of Hawaii's brightest leaving for Dot.Com opportunities. Historically risk-averse, Hawaii investors were accustomed to investing in real estate, established ventures, or out-of-state. They had very little if any interest in making investments in high-risk local tech start-ups. Frustrated local tech entrepreneurs, unable to get capital and faced with Hawaii's high cost of business, increasingly left Hawaii to launch start-ups elsewhere, were forced to leave Hawaii, or ultimately failed.



<u>Act 178 (Enacted in 1999)</u>

In 1999, policy makers recognized the economic significance of building Hawaii's emerging technology industry and its unmatched potential to diversify Hawaii's economy. The then-Governor Cayetano made developing Hawaii's technology industry – his top economic policy goal.

The Investment Tax Credit, a common economic development incentive offered by over half of US states, was an important element of Act 178, the "Technology Omnibus" bill, designed to support growth of Hawaii's technology companies. Initially created at 10%, the credit was specifically designed to incentivize local investors to put their capital in local tech companies.

The <u>specific intent</u> of the investment tax credit in Act 178 was to directly stimulate capital investments in Hawaii technology companies. Policy makers understood that without capital, the underlying goal of building Hawaii's technology industry would never be realized.

"While the advantages of Hawaii's proximity to Pacific and Asian markets are a lure for technology business in Hawaii, the costs of doing business are high. The purpose of this Part is to assist in the creation of opportunities for high technology companies through the creation of tax credits for investing in high technology businesses and for increasing research activities." – Act 178

The <u>long-term</u> policy goal was to accelerate the growth and development of a technology industry in Hawaii in order to diversifying the economy.

"Due to the State's current economic condition, your Committee recognizes the necessity of fostering the development of the high technology industry in Hawaii. High technology spans a variety of fields--from cutting edge bioengineering research, to the explosive growth of Internet commerce, to the development of advanced computer software. Because of this, high technology promises to be the major industry of the future, fast growing and enhancing our everyday lives in more ways than can be imagined. Your Committee's commitment to fostering high technology growth and development in this State will ensure Hawaii's prominent role as a mecca for high technology companies and a world-renowned center for innovation and invention. – Act 178 Conference Committee Report

In its earliest form, the investment tax credit provided:

- 10% credit
- $500,000 cap per investor per investment (includes carryover)
- QHTB Definition
    - Businesses in Hawaii
    - "Activities Test" - 100% Qualified Research (QR) or
    - "Income Test" - 100% gross income from QR
- QR Definition
    - Same as IRC 41(d) or
    - computer software
    - List of excluded activities identified

<u>Act 297 (Enacted in 2000)</u>

During the 2000 legislative session, Hawaii's economy continued to remain flat and the Dot.Com Bubble was at its peak. Based on industry feedback and scarce usage of the credit, policy makers realized that the credit's current form was not adequately meeting the desired impact and was not inducing investments in local tech companies. **With Act 297, lawmakers reinforced the original intent of stimulating growth of Hawaii's tech companies by building on the efforts initiated in Act 178. To hasten growth and enable more companies to take advantage of the credit, lawmakers reduced qualifying limits, added the biotech sector, and directed the credit to be "liberally construed".**

"Your Committee on Conference believes that the amendments in this bill will enable the State to strengthen its high technology industry, and are reflective of the progress made in this area as a result of the enactment of Act 178, SLH 1999. Your Committee finds that the package of incentives in this bill improves upon existing law." – Act 297 Conference Committee Report

"It is the intention of the legislature in making amendments……that the amendments be liberally construed, and in this regard, the department of taxation is given latitude to interpret those amendments in light of current industry standards……shall not be construed to disqualify any taxpayer who has received a favorable written determination from the department of taxation under the original provisions of those sections as enacted by Act 178." – Act 297

Investment Tax Credit Amendments:

- QHTB Definition
  - Reduced "Activities Test" – from 100% QR to QR to more than 50% QR with added requirement that 75% of QR must be performed in Hawaii
  - Reduced "Income Test" – from 100% to 75%
  - Removed "performing arts" from excluded list
- QR Definition
  - Improved definition of computer software (Strengthened focus to advanced technologies)
  - Added Biotechnology

<u>Act 221 (Enacted in 2001)</u>

Adding to Hawaii's continued economic slump, the crashing Dot.Com Bust caused policy makers to realize that for Hawaii to have any chance to become competitive, they needed to intensify efforts, accelerate progress and drive change. The incremental changes made to the investment tax credit in the previous 2 years had done little they realized that ordinary improvements were not enough. **To induce investors to fund high-risk local tech start-ups, <u>fundamentally required changing mindset and behavior</u>. This required something bold, compelling, that would set Hawaii apart.** Something dramatic was required to grab the interest of investors and bring about the desired shift in attitudes and behavior. Hawaii was at a fork in the road. Demonstrating courage and vision, policy makers showed the world an unequalled commitment to technology with Act 221. Modeled after the low-income tax credit program, the Investment Tax Credit in Act 221/215 offered an unparalleled 100% tax credit over five years to investors in Hawaii qualified high-tech businesses.

The intent was to generate immediate excitement and interest from local investors, giving companies the jumpstart they needed, and immediately draw global recognition to the state. Act 221's investment tax credit was designed to excite investors and accelerate the growth of Hawaii technology companies, as well as attract the attention of technology companies and investors worldwide looking for expansion and investment opportunities. This in turn would help attract investment capital, high-quality employment, and ultimately diversify the economy.

"Through Act 178, Session Laws of Hawaii (SLH) 1999, and Act 297, SLH 2000, the legislature provided a platform to encourage the continued growth and development of high technology businesses and associated industries in Hawaii. These legislative efforts have resulted in growing interest in Hawaii as a "New Economy" marketplace. Additional incentives must now be put in place to set Hawaii apart as a tech-friendly place to do business for both technical and non-technical businesses." – Act 221

Amendments to investment tax credit:

- Increased credit from 10% to 100%
- Increased cap from $500,000 to $2M
- Frontloaded (35%, 25%, 20%, 10%, 10%) over 5 years
- 10% recapture provision

- QR Definition Additions
  - Performing arts products
  - Sensor and optic technologies
  - Ocean sciences
  - Astronomy
  - Nonfossil fuel energy-related technology

<u>Act 215 (Enacted in 2004)</u>

Over the 2 ½ years since the passage of Act 221, a number of events contributed to the development and passage of Act 215 including:

- With increased access to capital provided by Act 221, local tech companies steadily expanded. As these companies successfully completed their initial rounds of funding, their capital needs also grew. With the long-term intent of building a tech industry in Hawaii, it was clear that without access to venture capital, the positive results of Act 221 would not be maximized. These expanding companies held the greatest potential and were at their most critical growth stage – when the most jobs and revenues would be generated. Lawmakers recognized that stimulating the development of local venture capital, would enable these growing tech companies to stay in Hawaii and deliver the intended returns to the local economy of high-paying jobs and increased revenues.

- There was a significant increase of investments in local tech companies. In 2 years, investments in Hawaii QHTBs grew from less than $400,000 to over $145M.

- The substantial increase in investments was a clear indication of the positive impact of the credit and directly met legislative intent. Rather than acknowledging the long-term value of this growth realized in investments and companies, the state administration focused on the potential and future costs of the credits. Preliminary data on the number of credits were often misleading and heightened media and public's concerns.

- Changing data and unsubstantiated comments from the administration and others about misuses of the credit perpetuated and intensified media-driven controversy surrounding Act 221.

- The controversies surrounding Act 221 created enough uncertainty for investors adversely affecting their attitudes and interest in investing in QHTBs. Investors grew increasingly uneasy about the credit's stability and were disinclined to participate in Act 221 deals. Tax Dept. data for 2003 reflects this negative effect showing a notable decrease of $13.38M in investments in 2003. 2004 data is not available. The controversy itself negatively affected the incentive's success, ultimately undermining the incentive's long-term potential.

- The inclusion of "performing arts" under the definition of Qualified Research created an unintended consequence. The original intent underlying the inclusion was based on a number of factors such as the unquestionable global convergence of information technology with media/entertainment. The potential for this industry in Hawaii was valid and real with the rapid growth of companies like SquareUSA and the incredible rise of computer-generated gaming and entertainment products . The controversy reached its peak with the administration's disclosure of 3 movie productions that obtained Act 221 investment tax credits. It is interesting to note that although these productions generated sizable total credits, the anticipated number of credits they will actually claim is less than 50% of the total credits as the nature of this industry is transient. After about a year generating 35% of claimed credits, these productions will disband, triggering the recapture provision.

- It became quickly clear that the Department of Tax needed additional expertise to adequately evaluate the complexities of the diverse technology sectors involved and additional resources to administer the credit on a timely basis. A significant point to acknowledge is that Act 221 did not allocate any additional funds to the Tax Dept. when enacted. On top of all the Tax Dept.'s regular mandates, in hindsight, it was an unrealistic expectation to require effective implementation of a new and complicated credit with rapidly growing utilization without providing additional resources.

- With the controversies surrounding Act 221 and the unreliable and frequently changing data, lawmakers felt an increasing need to set up a process for data collection. Because of the confidential nature of the data, the Tax Dept. was the only suitable department to be responsible for this data.

- September 11, 2001

Given these events, lawmakers passed Act 215 with the intent to balance the need to properly address the controversies while continuing to build upon the considerable momentum generated by Act 221. With the rapidly growing numbers of tech companies and the success of companies like Hoku Scientific, Blue Lava, and STI, lawmakers reaffirmed their commitment to realizing the vision of Hawaii's tech industry by extending the law's sunset date and improving its implementation and effectiveness.

"The purpose of this bill is to continue to support the state's high technology industry."
"Your Committee finds that the high technology business in Hawaii is growing quickly and maturing into a promising and competitive industry. To continue growing and to ensure that these industries remain in Hawaii, new financing opportunities must be developed and implemented."
"Your Committee also finds that the changes to the high technology tax incentives will continue to foster the growth of these businesses, especially the small businesses just starting out. – Act 215 Conference Committee Report

"This part improves currently available tax incentives developed for the high technology industry. Primary among these is Act 221, Session Laws of Hawaii 2001. Act 221 still contains essential incentives that continue to encourage the growth and development of high technology businesses and associated industries." – Act 215

Amendments to investment tax credit:

- Extended sunset date 5 years to 2010
- Added Certification process (credits are pre-certified prior to filing the actual claim and claimant data is collected by the Tax Dept.)
- Added ability to collect administration fees for rulings/certifications
- No changes to definition of QHTB
- Changes to Qualified Research Definition
    - New Computer Software
    - Application of doctrines of economic substance and business purpose to credit allocation ratio*
        - ≤1.5 Presumption met

- >1.5 to 2 Dept. review
- >2 Substantiation required
- Deletion “liberally construed” - replaced with “construed in a manner consistent with the intent of the Act”

* *“The bill, as received, provided Department of Taxation (DOTAX) with guidance on how to evaluate the various claims for this credit by using the ratio of investment to tax credit claimed as an indication of which claims met the purpose of this tax credit. However, your Committee wants to clearly state that these ratios are only guidance and should not be used as a bright line test of credit approval. Rather, these ratios should be considered one factor among many in the evaluation of which credits should be allowed to be claimed.” – Act 215 Conference Committee Report*

“It is the intention of the legislature in making amendments in this Part to sections 235-7.3, 235-9.5, 235-110.9, and 235-110.91, Hawaii Revised Statutes, that the amendments be construed in a manner consistent with the intent of this Act. The department of taxation is further given latitude to interpret those amendments in light of current industry standards. The amendments made in this Part to sections 235-7.3, 235-9.5, 235-110.9, and 235-110.91, Hawaii Revised Statutes, shall not be construed to disqualify any taxpayer who has received a favorable written determination from the department of taxation under the original provisions of those sections as enacted by Act 178, Session laws of Hawaii, 1999." – Act 215

<u>Note on Certification Process and data collection:</u>

The intent of this provision as is established in *Act 215 Conference Committee Report was: “Establishing reporting requirements for those claiming a qualified high technology business tax credit or a research activities tax credit to provide more public information about the use of these credits.” Actual wording from Act 215 is below:*

(e) Every taxpayer, before March 31 of each year in which an investment in a qualified high technology business was made in the previous taxable year, shall submit a written, certified statement to the director of taxation identifying:

(1) Qualified investments, if any, expended in the previous taxable year; and

(2) The amount of tax credits claimed pursuant to this section, if any, in the previous taxable year.

(f) The department shall:

(1) Maintain records of the names and addresses of the taxpayers claiming the credits under this section and the total amount of the qualified investment costs upon which the tax credit is based;

(2) Verify the nature and amount of the qualifying investments;

(3) Total all qualifying and cumulative investments that the department certifies; and

(4) Certify the amount of the tax credit for each taxable year and cumulative amount of the tax credit.

Upon each determination made under this subsection, the department shall issue a certificate to the taxpayer verifying information submitted to the department, including qualifying investment amounts, the credit amount certified for each taxable year, and the cumulative amount of the tax credit during the credit period. The taxpayer shall file the certificate with the taxpayer's tax return with the department.

The director of taxation may assess and collect a fee to offset the costs of certifying tax credits claims under this section. All fees collected under this section shall be deposited into the tax administration special fund established under section 235-B.

This Certification Process which pre-certifies credits being claimed and collects data has caused a significant amount of administrative problems, costs, delays, confusion and frustration, mutually shared by investors, QHTB companies, tax professionals and Tax Department staff. Timing of data was at the heart of this provision. Pre-certification was an attempt by lawmakers to ensure the Tax Dept. was given data about the credits being claimed 9 months prior to the start of the next legislative session, so that lawmakers and the public would be able to consider more up-to-date data during the session. Inserted during the rush of Conference in the last days of the 2004 session, the provision was included with insufficient input from the private sector. Given the unchanged lack of data as demonstrated in the draft study in which only 2 years of reliable data is available (2001 and 2002), it does not appear that this provision has made any improvement on the timing of data being made available.

In addition, the QHTB data collected by the Tax Dept. from tech companies about jobs, expenditures, and investments on Form N-317 is one of, if not the most, important source of data – as it is specifically connected to the incentive. Data from sources such as Department of Business, Economic Development and Tourism and Dept. of Labor is problematic in that discrepancies in the categorization of jobs and types of companies do not accurately reflect the types of jobs and companies related specifically to the investment tax credit.

CONCLUDING COMMENTS

- Industry agrees that the investment tax credit should be tracked and evaluated on its effectiveness.
- A report based on incomplete and inaccurate data, that does not fully consider the important policy intent behind the incentive may create misleading interpretations and confusion that will undermine the effect of the incentive.
- An accurate analysis must include:
  - Collaboration between all parties: industry, policy makers, Tax Dept.
  - Valid empirical data
  - Established benchmarks directly related to the policy goals.
- A new system of data collection or additional legislation is not needed.
- The Tax Dept. is already collecting the key data elements needed.
- The disclosure of data being collected should be agreed upon by all parties
  - Respect taxpayer confidentiality
  - Appropriately aggregated or segmented
  - Suitable and set time intervals (In the past, data has been disclosed when required by an outside party or at the discretion of the Tax Dept.)
- The Tax Dept. must be provided with additional expertise and resources to effectively administer the credit.

One Last Comment on Jobs and Benchmarks

Given the policy goals detailed, there are a number of benchmarks we believe must be considered.

- Fulfilling its intent, Act 221 succeeded in changing investor attitudes and behavior – causing fundamental changes in Hawaii's tech environment. Compared to 2001, not only has the number of investors increased dramatically, Hawaii now has expanding angel networks on multiple islands, more venture funds, more tech accelerators and incubation space, and a visible increase in the community's interest and experience investing in Hawaii technology.
- It is also very important to consider the additional intended goals, such as increasing Hawaii's tech visibility, improving the state's business image, preventing relocations thus retaining jobs, revenues, and skills, and the expanding knowledge and indirect jobs and taxes generated by local supporting service providers to Hawaii's tech industry.

In evaluating Act 221 jobs, in addition to the number of jobs produced, of even greater importance is the types of jobs created by these technology companies. In comparison to 100 hospitality jobs with an annual avg. wage that is less than $25,000, the same number of tech jobs with $50,000+ avg. salaries is undeniably of greater economic value. It is also important to note that Act 221 has not only produced high-paying jobs with the skills demanded in the global economy, but has also enabled hundreds of kama'aina to come back home – tangibly beginning to reverse Hawaii's "brain drain".

In addition, when evaluating the number of technology companies, it is very important to differentiate between QHTBs versus those companies still categorized as technology companies, but are not eligible to be QHTBs.

Attachment 2

ACCURATE ANALYSIS ON ACT 221/215 REQUIRES PRIVATE/PUBLIC COLLABORATION

Enacted in 2001, the direct intent of Act 221 was to stimulate capital investments in Hawaii technology companies, thereby accelerating the growth of our local tech industry. Hawaii investors, accustomed to investing in real estate, established ventures, or out-of-state, had very little if any interest in making investments in local tech start-ups. Frustrated tech entrepreneurs increasingly left Hawaii to launch ventures or were eventually forced to relocate to areas with greater access to capital. With the collapse of both Japanese and Dot.Com bubbles, visionary lawmakers recognized the long-term importance of this industry in diversifying Hawaii's economy and creating high-paying jobs. To induce investors to fund high-risk local tech start-ups, fundamentally required changing mindset and behavior. To effectively achieve this required something bold, compelling and exceptional. Act 221, drew immediate global visibility and recognition to Hawaii, with a 100% tax credit over 5 years for investors in qualified high tech businesses in Hawaii, as well as other incentives for these tech companies.

On October 6, 2006, a draft study commissioned by the State's Tax Review Commission was presented by Professors Bruce Bird and Marcia Sakai. The Study, focused on the Act 221 investment tax credits, uncovered some promising data on significant investment and job growth already being realized. For some reason, this positive data was lost in interpretation. The way the data were interpreted, the multiple contradictions, and how the Study was conducted, does not meet the level of accuracy and objectivity required in a responsible analysis. The professors themselves acknowledged inaccuracies and limitations on their findings and their omission in failing to talk to the basic participants of Act 221.

Industry members agree that a study of Act 221 should be done. Understanding its effectiveness is important to everyone. But such a study must be accurate, objective, adequately consider both quantitative and qualitative factors, clearly establish criteria for effectiveness, and directly address issues related to law's intent. It should not be based on static model analysis, inaccurate press reports, misleading hypotheticals, incorrect assumptions, and in particular, should not mistakenly interpret data unrelated to Act 221.

• The study contained multiple instances where the authors drew conclusions contradicting their own cited data.

o The cited State Tax Department data reported more than $81.8 million of Act 221 investments made in 2002. Contradicting this primary source, the Study concluded that Act 221 has failed to increase investments in Hawaii relying on an inaccurate mainland study that showed only $2.9 million investments in 2002 because most Hawaii investors were not included in this mainland study.

o The Tax Department reported over 4,000 Act 221-related jobs were created in 2002 and 2003. But the Study concluded an overall loss in technology jobs based on data from the Department of Business, Economic Development and Tourism (DBEDT). Unfortunately, the DBEDT data erroneously included NON-Act 221 industry sectors. A closer analysis of DBEDT's data showed more than a 23% INCREASE of tech jobs in qualified Act 221 sectors.

• Due to lack of context, the authors failed to recognize and consider one of the most important benefits of Act 221. Fulfilling its intent, Act 221 succeeded in changing investor attitudes and behavior – causing fundamental changes in Hawaii's tech environment. Compared to 2001, not only has the number of investors increased dramatically, Hawaii now has expanding angel networks on multiple islands, more venture funds, more tech accelerators and incubation space, and a visible increase in the community's interest and experience investing in Hawaii technology. The Study also failed to consider other benefits meeting the law's intent, such as increasing Hawaii's tech visibility, improving the state's business image, preventing relocations thus retaining jobs, revenues, and skills, and the expanding knowledge and indirect jobs and taxes generated by local supporting service providers to Hawaii's tech industry.

• One goal specifically contemplated by the Legislature for Act 221 was to attract capital from mainland, foreign, and tax-exempt sources by permitting the allocation of credits from their investments to Hawaii taxpayers. Act 221 has fostered these new sources of capital. The professors failed to include this obvious benefit in their analysis.

• In evaluating Act 221 jobs, the authors focused on the number of jobs produced, but failed to give sufficient weight to the types of jobs being created. In comparison to 100 hospitality jobs with an annual avg. wage that is less than $25,000, the same number of tech jobs with $50,000+ avg. salaries is undeniably of greater economic value. It is also important to note that Act 221 has not only produced high-paying jobs with the skills demanded in the global economy, but has also enabled hundreds of kama'aina to come back home – tangibly beginning to reverse Hawaii's "brain drain"

The community deserves a more comprehensive and thoughtful analysis and to achieve this requires collaboration between private and public sectors. Industry is committed to working together on a more meaningful effort.

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Attachment 3

EXISTING ACT 221 DATA DESERVES ACCURATE AND OBJECTIVE ANALYSIS

Enacted in 2001, the specific intent of Act 221 was to stimulate capital investments in Hawaii technology companies, thereby accelerating growth of viable local tech industry. Substantial local capital existed - but little if any was being invested in local tech companies. Without local capital, Hawaii entrepreneurs could not build companies or attract outside investors. 221 was intended to stimulate both. But changing mindset and behavior would not be easy – given recent Dot.Com and Japanese Bubble Busts. Lawmakers recognized that a bold and compelling incentive was needed for real change. Building Hawaii's emerging tech industry represented the most effective way to attain economic diversification and create high-paying living-wage jobs.

Given this background, the draft study (the "Study") by Professors Bruce Bird and Marcia Sakai presented to the State's Tax Review Commission on Friday, October 6, 2006 uncovered some promising data on significant investment and job growth already realized from Act 221. For some reason, this positive data is lost in interpretation. The way data was interpreted, the multiple contradictions it contained, and how the Study was conducted, does not meet the level of accuracy and objectivity required in a responsible analysis. The professors themselves acknowledged inaccuracies and limitations on the Study's findings and their omission in failing to talk to the basic participants in Act 221.

Industry agrees that a study of Act 221 should be done. But such a study must be accurate, objective and not based on static model analysis, inaccurate press reports, misleading hypotheticals, incorrect assumptions, and in particular, it should not erroneously interpret data that is not even related to Act 221.

- The study contains multiple instances where the authors make conclusions that directly contradict their own cited data.
  - The Hawaii State Tax Department data cited in the Study reported more than $81.8 million of Act 221 investments made in 2002. Contradicting this primary source data, the Study concludes that Act 221 has failed to increase investments in Hawaii based on secondary data from a mainland study that inaccurately showed 2002 investments of only $2.9 million because most Hawaii investors were not included in this mainland study.
  - The Tax Department reported over 4,000 Act 221-related jobs were created in 2002 and 2003. But the Study concludes that there was an overall loss in technology jobs based on data from the Department of Business, Economic Development and Tourism (DBEDT) that showed job losses. Unfortunately, the DBEDT data erroneously included NON-Act 221 industry sectors. A closer analysis of DBEDT's data actually shows an INCREASE of more than 23% of tech jobs in actual qualified Act 221 sectors.

- Because the Study's authors did not talk to many industry representatives, technology companies, or even the Director of Taxation, the Study is devoid of any real world understanding of how Act 221 actually works. This basic lack of context further contributes to the study's inconsistencies and misunderstanding of Act 221/215 and Hawaii tax law.

- The Study uses static input-output economic models that do not account for dynamic contributions to the economy. It ignores jobs created for independent contractors, employee leasing companies and other vendors and service providers to high tech companies. It fails to sufficiently consider increased payroll, income, and general excise taxes generated by not only tech companies, but also their vendors and service providers.

- The Study fails to account for qualitative benefits that accrue with a vibrant tech presence. Act 221 has contributed to making Hawaii known as a tech-friendly place to do business. Never before has Hawaii experienced so many inquiries about starting tech businesses in Hawaii. Not to mention the countless number of companies that have chosen to remain in Hawaii versus relocating to the mainland, or that avoided insolvency from undercapitalization.

- One goal specifically contemplated by the Legislature for Act 221 was to attract capital from mainland, foreign, and tax-exempt sources by permitting the allocation of credits from their investments to Hawaii taxpayers. Act 221 has fostered these new sources of capital. The professors failed to include this obvious benefit in their analysis.

- The Study maintains that Hawaii does not have the infrastructure or labor expertise to keep successful tech companies in Hawaii and that Hawaii is the most expensive State to conduct business. Act 221 has been successful in helping to "level" the playing field by supporting home grown startups, attracting out of state investors, drawing mainland companies to relocate to Hawaii, and enabling companies to be successful and stay in Hawaii. It is also important to note that Act 221/215 has not only provided high-paying local jobs, but has significantly enabled growing numbers of kama'aina to come back home – reversing the "brain drain" of the past.

A comprehensive and thoughtful analysis is needed and to achieve this requires collaboration between private and public sectors. Industry is committed to working together on this effort.

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1. **TECH INDUSTRY ALSO WANTS DATA & ANALYSIS**: Industry has always asked for release of AGGREGATE data broken down by QHTB categories. It is only the disclosure of the names of the INVESTORS that require respect for confidentiality. AGGREGATED investor data - especially number of investors - should be provided.

2. **PRIMARY SOURCE OF DATA**: Tax Dept. is single source of primary data. Due to confidential nature of taxpayer info, no one else can collect it. Tax Dept has even collected jobs created/projected data – which is more reliable/accurate because it's job counts ONLY from QHTBs. Reports from secondary sources of job data do not separate QHTB jobs from other tech jobs or non-tech sectors.

3. **PRIMARY SOURCE DATA <u>EXISTS</u> – HAS <u>ALREADY BEEN COLLECTED</u> BY TAX DEPT**
   Tax Dept. requires & has already collected detailed data on both QHTBs & Investors – via Comfort Ruling Requests, N-317, N-318A, Certification Process (submitted under penalty of perjury & added cost)

4. **GIVE THE <u>SAME AGGREGATED</u> DATA TO <u>EVERYONE</u> – AT <u>SET TIMES</u>**: Issue is COMPILING, AGGREGATING & REPORTING - SAME data to EVERYONE – at SAME TIME – AGREED UPON INTERVALS
   - Past data issued when forced/required/at Tax Dept's discretion.
   - Past data given in pieces, in different forms, parts, measurements, names, visuals, ways
   - Enormous confusion due to INCONSISTENCIES & CONTRADICTIONS between data issued at different times (Ex. – data reported by Hon Advertiser 10/24 <u>does not match</u> data used for the draft study.
   - Unclear which data is correct data – need standardized data given to everyone at same time.
   - If limited resources – Use fees for data entry or industry assist development secure electronic collecting.

5. **RELIABILITY OF ESTIMATES/PROJECTIONS**: Past data contained estimates /projections causing controversy. Occurences where projections found later inaccurate, but damage done to public/investor perceptions.

6. **BENCHMARK DATA WITH POLICY GOALS:** Clear benchmarks aligned with policy INTENT should be established/agreed upon by parties involved incl. policy makers, Tax Dept., tech industry reps. Parties should collaborate more – ex. industry assist DoTax communicating to members/collect agreed-upon non-tax data.

7. **INVESTOR BENCHMARK:** Intended target of behavior change was INVESTOR & more investor-related data should be included in analysis, incl. (Amt of investments; Number/types of investors; Indicators of local investment community change -ex. Number/Amt invested by Angel Networks, VCs, corporations, institutional; Qualitative data on Attitudes/Changes in angels, vcs, businesses, institutional investors.

8. **SERVICE PROVIDERS TO QHTBS/INVESTORS:** Measure skills/experience/number of companies supporting tech – lawyers/accountants/clinical trials/research/etc. Before Act 221, most local tech companies used mainland firms due to lack of expertise. With increased tech, QHTBs use local or both – retaining jobs, expenditures, skills.

9. **TYPE OF TECH JOB – NOT JUST NUMBER**: QHTBs funded with angel/start-up funding will not produce hundreds of jobs. In a few years, if company successfully completes initial funding rounds & progresses to expansion phase, job numbers will escalate quickly.
   - TYPE of jobs created more important. Compared to 100 hospitality jobs (avg. wage <$25,000), 100 tech jobs (avg wage >$59,000) deliver greater economic value. Multiple studies revealed a strong relationship between tech growth in a given year and non-tech growth the following year. Jobs RETAINED also important.
   - Who's taking these jobs? QHTB growth has begun one of only concrete ways to reverse years of "brain drain", enabling hundreds of kama'aina to come back home.

10. **TAX CUT:** Act 221 Tax Credits are NOT government spending, but TARGETED TAX CUTS that allow Hawaii taxpayers to invest their tax money into local tech companies.

Attachment 5

www.hawaiiscitechcouncil.org www.enterprisehonolulu.com www.hawaiiangels.org www.hvca.org

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Act 221/215 - Investment Tax Credit

Tech Industry Comments

Tax Review Commission Meeting

October 25, 2006

INTENT OF THE ACT 221/215 INVESTMENT TAX CREDIT

What was the policy goal of this unprecedented landmark legislation?

To fully understand intent – economic/political history and prior Acts in series must be revisited.

Hawaii's Economic Environment - Before 1999

⬇ 1990's One of worst economic periods in Hawaii's history – Decade of economic slump

⬇ Persian Gulf War ⬇ Burst of Japan's "Bubble" economy ⬇ Hurricane Iniki

⬇ Late 1990's Height of Dot.Com Bubble – Little/No impact in Hawaii

⬇Decade of Brain Drain worsened by exploding Dot.Com opportunities

⬇ Hawaii investors - risk-averse - Little/No interest in investing in high-risk local tech start-ups

⬇ Frustrated entrepreneurs – unable to get capital/cost of doing business – Left the state or failed

Act 178	→	Act 297	→	Act 221	→	Act 215
1999		2000		2001		2004
Technology Omnibus		New Economy		Tech Tax Amendments		Capital Investments

Act 178 (Enacted in 1999)

⬇ Dot.Com Bubble – Successes on mainland - little impact on Hawaii continued economic slump. Policy makers recognized building local tech industry was best chance for long-term economic diversification. The investment tax credit was initially set at 10%.

POLICY INTENT

Specific = Stimulate investments in Hawaii tech companies.

Long-term = Accelerate growth of Hawaii's tech industry and diversify the economy.

Act 297 (Enacted in 2000)

⬇ Hawaii's economy remained flat – during Peak of Dot.Com Bubble.

Current form of investment tax credit was attracting very little usage - policy makers determined improvements were needed to improve its appeal to investors.

POLICY INTENT = Reinforce Act 178 goal to stimulate growth of local tech companies – by enabling more tech companies to qualify as a "Qualified High Tech Business" (QHTB). Reduced Qualified Research restrictions, added biotech sector, instructed Tax Dept. to "liberally construe" application of the credit.

Act 221 (Enacted in 2001)

⬇Adding to Hawaii's continued economic slump – Dot.Com Bust
Policy makers realized it was time to act – not just talk.
Hawaii's tech competitiveness was so far behind other regions, that a viable role in the global technology economy, required a powerful spark to ignite growth and set the momentum.

- **But to stimulate investors to invest in Hawaii's local start-ups, fundamentally required – a change in mindset and behavior.**
- **This required something bold, compelling, and convincing – that would also set Hawaii apart.**
- **Dramatic enough to grab their attention and turn around their risk-averse attitudes and behavior.**

Policy makers demonstrated great vision and courage, establishing the state's competitiveness in the New Economy with Act 221 – unparalleled 100% tax credit over 5 years to investors in Hawaii's tech companies.

🌍POLICY INTENT

- **Generate immediate excitement and interest from investors to invest in Hawaii's local tech companies**
  - **⤷ To give local companies a jumpstart on growth**
- **Bring immediate global recognition and visibility to the state**
  - **⤷ To improve Hawaii's business and create a "tech friendly" image**
    - **⤷ To attract attention of tech companies and investors outside the state**

⬇ ⬇ ⬇ ⬇ ⬇ ⬇ ⬇

🌍 **Accelerating growth of Hawaii's technology industry**
  ⤷ To create high-paying jobs and an economic driver for diversification

- Act 221 investment tax credit structure was patterned after the low-income housing credit, but without annual caps and designed to remove perception of political interference. The disadvantage to removing governmental control was the confidential nature of these credits. For performance measurements, this was simple to overcome by capturing benchmark data but reporting it in aggregate form.

- Since Act 221's start in 2001, Hawaii's investment culture and business environment has transformed – Hawaii's past risk-averse mindset has sprouted new angels and expanding angel networks, mainland venture capital, more dealflow , new and offshore tech companies, and a concrete way of reversing the state's past "Brain Drain" enabling over a hundred plus kama'aina to come back home. Changing mindset and behavior

- The INTENT of Act 221 was to effect meaningful change in Hawaii's economy.

Attachment 6

HAWAII SCIENCE & TECHNOLOGY COUNCIL — www.hawaiiscitechcouncil.org
ENTERPRISE HONOLULU — www.enterprisehonolulu.com
HAWAI'I Angels — www.hawaiiangels.org
HAWAI'I VENTURE CAPITAL — www.hvca.org

Act 221/215 - Investment Tax Credit
Tech Industry Comments
Tax Review Commission Meeting
October 25, 2006

INTENT OF THE ACT 221/215 INVESTMENT TAX CREDIT

Act 178	→	Act 297	→	Act 221	→	Act 215
1999		2000		2001		2004
Technology Omnibus		New Economy		Tech Tax Amendments		Capital Investments

Act 215 (Enacted in 2004)
Over the 2 ½ years since Act 221, many events contributed to what & why changes were made creating Act 215:

- September 11, 2001

- With increased access to capital provided by Act 221, local tech companies steadily expanded. As these companies successfully completed their initial rounds of funding, their capital needs also grew. With the long-term intent of building a tech industry in Hawaii, it was clear that without access to venture capital, the positive results of Act 221 would not be maximized. These expanding companies held the greatest potential and were at their most critical growth stage – when the most jobs and revenues would be generated. Lawmakers recognized that stimulating the development of local venture capital, would enable these growing tech companies to stay in Hawaii and deliver the intended returns to the local economy of high-paying jobs and increased revenues.

- There was a significant increase of investments in local tech companies. In 2 years, investments in Hawaii QHTBs grew from less than $400,000 to over $145M.

- The substantial increase in investments was a clear indication of the positive impact of the credit and directly met legislative intent. Rather than acknowledging the long-term value of this growth realized in investments and companies, the state administration focused on the potential and future costs of the credits. Preliminary data on the number of credits were often misleading and heightened media and public's concerns.

- Changing data and unsubstantiated comments from the administration and others about misuses of the credit perpetuated and intensified media-driven controversy surrounding Act 221.

- The controversies surrounding Act 221 created enough uncertainty for investors adversely affecting their attitudes and interest in investing in QHTBs. Investors grew increasingly uneasy about the credit's stability and were disinclined to participate in Act 221 deals. Tax Dept. data for 2003 reflects this negative effect showing a notable decrease of $13.38M in investments in 2003. 2004 data is not available. The controversy itself negatively affected the incentive's success, ultimately undermining the incentive's long-term potential.

- The inclusion of "performing arts" under the definition of Qualified Research created an unintended consequence. The original intent underlying the inclusion was based on a number of factors such as the unquestionable global convergence of information technology with media/entertainment. The potential for this industry in Hawaii was valid and real with the rapid growth of companies like SquareUSA and the incredible rise of computer-generated gaming and entertainment products . The controversy reached its peak with the administration's disclosure of 3 movie productions that obtained Act 221 investment tax credits. It is interesting to note that although these productions generated sizable total credits, the anticipated number of credits they will actually claim is less than 50% of the total credits as the nature of this industry is transient. After about a year generating 35% of claimed credits, these productions will disband, triggering the recapture provision.

- It became quickly clear that the Department of Tax needed additional expertise to adequately evaluate the complexities of the diverse technology sectors involved and additional resources to administer the credit on a timely basis. A significant point to acknowledge is that Act 221 did not allocate any additional funds to the Tax Dept. when enacted. On top of all the Tax Dept.'s regular mandates, in hindsight, it was an unrealistic expectation to require effective implementation of a new and complicated credit with rapidly growing utilization without providing additional resources.

- With the controversies surrounding Act 221 and the unreliable and frequently changing data, lawmakers felt an increasing need to set up a process for data collection. Because of the confidential nature of the data, the Tax Dept. was the only suitable department to be responsible for this data.

INTENT = Given these events, lawmakers passed Act 215 with goal to balance need to address controversies to some degree while sustaining the INTENT of Act 221. Lawmakers agreed on need to address the funding gap – and enacted SPIF, but delayed it's implementation. Numbers of tech companies were growing and successes Hoku Scientific, Blue Lava, and STI, reinforced the need to maintain the momentum. Because the intense controversies of the last 2 years undermined its true effectiveness, additional time was needed to truly support the intent.

Amendments to investment tax credit:

- Extended sunset date 5 years to 2010
- Added Certification process (credits pre-certified prior to filing actual claim & detailed data is collected)
- Added ability to collect administration fees for rulings/certifications
- No changes to definition of QHTB
- Changes to Qualified Research Definition
    - New Computer Software
    - Application of doctrines of economic substance and business purpose to credit allocation ratio*
      ≤1.5 Presumption met; >1.5 to 2 Dept. review; >2 Substantiation required
- Deletion "liberally construed" - replaced with "construed in a manner consistent with the intent of the Act"

<u>EVALUATING EFFECTIVENESS OF ACT 221/215</u>

- Even with improvements made in latest version, Act 221/215 INTENT remains the same- to effect meaningful change in Hawaii's economy. Incredible progress has been made and signs of growth continue to build.
- Policy goals provide the framework from which BOTH qualitative and quantitative data should be evaluated upon. Some questions to consider:

1. Has Act 221 changed investor behavior? Are they investing in QHTBs? Impact other types of investments? Is number of investors growing? Has it changed investment/business community?
2. Has Act 221 accelerated growth of local tech companies? What is impact on developing Hawaii's tech industry?
3. What is impact of Act 221 on Hawaii's economy? Impact on other local industries? Impact on education, other state priorities? Is Hawaii competitive? Improved business image? Greater visibility?

ACT 221 INVESTMENT TAX CREDIT
RELEASE THE SAME AGGREGATE DATA - TO EVERYONE – AT SAME TIME – AT PRE-SET TIMES

The issue of the lack of data is something everyone agrees on. But an important distinction must be made. THE DATA EXIST AND HAS BEEN COLLECTED BY THE DEPARTMENT OF TAXATION.
The central issue is the RELEASE OF THE DATA, WHICH HAS ALREADY BEEN COLLECTED.
No accurate analysis can be done without this data.

1. TECH INDUSTRY ALSO WANTS DATA & ANALYSIS: Industry has always maintained the need for data and monitoring. Data should be collected and tracked, but measurements of effectiveness should not be done prematurely. Countless requests have been made asking for AGGREGATE data broken down by tech category. Confidentiality should be respected regarding NAMES of INVESTORS - as disclosing investors names will adversely affect their interest in investing in local tech companies. Disclosing NAMES of QHTBs can be provided – but any other confidential info about the companies (such as revenues, costs, jobs) should be disclosed in AGGREGATE form. Rather than stimulating investments, identifying investor names or disclosing individual company data directly contradict intended policy goal - deterring investors and causing competitive disadvantages for the very companies we are trying to grow. Releasing AGGREGATE investor data and AGGREGATE QHTB data provide more than adequate benchmarks, yet maintain the confidentiality required and fulfill the policy objective intended.

2. PRIMARY SOURCE OF DATA: The Tax Dept. is the SINGLE, LOGICAL source of primary data. No one else can get access to complete and accurate investor and QHTB data – mandated and submitted under penalty of perjury. DATA ON JOB CREATION, has also been collected by the Tax Dept – and represents the most accurate data because it ONLY COUNTS the jobs of QHTBs. Secondary sources of job data are important for comparisons, but less reliable because they cannot separate QHTB from other Non-Act 221tech jobs or non-tech sectors jobs.

3. PRIMARY DATA <u>EXISTS</u> AND HAS <u>ALREADY BEEN COLLECTED</u> BY THE TAX DEPT
The Tax Dept. has already collected detailed data on both QHTBs & Investors from forms required and filed with the Tax Department under penalty of perjury and at considerable costs to investors and QHTB's. Forms include Comfort Ruling Requests, N-317, A-9A, N-318, and N-318A. List of exact data elements are attached.

4. RELEASE THE <u>SAME AGGREGATE</u> DATA TO <u>EVERYONE</u> – AT <u>SAME TIME</u> – AT PRE-<u>SET TIMES</u>
Data released to date has been piecemeal and very inconsistent with respect to presentation, metrics measured and identified. Most importantly, data released by the Tax Dept. to date has often CONTRADICTED its prior releases of the SAME data. This has caused enormous confusion and misleading headlines. (Example: – data reported by the Honolulu Advertiser on 10/24/06 <u>does not match</u> Tax Department data reported in the Tax Review Commission Bird/Sakai draft study.)

The Tax Dept. should release standardized, aggregate data to all interested parties - at the same time – and at predictable, agreed-upon times. Limited resources should be sufficiently addressed by the new filing fees imposed by the Department of Taxation on Act 221/215 related filings.

The Tax Dept. has already collected much PRIMARY SOURCE data. Below are the forms and types of key data (much more is actually collected) that are already reported to the Tax Dept. and are required by investors and QHTBs utilizing the Act 221/215 Investment Tax Credit.
Copies of forms are available at: http://www.hawaii.gov/tax/a2_b2_6hi_tech.htm

DATA ALREADY COLLECTED FROM QHTBs BY TAX DEPT.

- N-317 (Required each calendar year)
    - Company Name
    - Inception Date
    - QHTB Category of Company (from QHTB defined list)
    - Number of Jobs since inception
    - Number of new jobs created during the submitting year
    - Total salaries paid in submitting year
    - Number of employees paid in submitting year
    - Other tax incentives claimed or expected to be claimed
    - Total amount of investments received in submitting year
    - Name/address/ssn of each investor
    - Amount/date/description of investment
    - What investor received in return for investment
- REQUEST FOR A HIGH TECH COMFORT RULING (Not required but submitted by nearly all QHTBs)
    - Name/address/Identification Numbers
    - Description of qualified research activities
    - Substantiation to fulfill Activities Test (>50% Qualified Research and >75% of QR in Hawaii
    - > 75% of Company's gross income will be derived from Qualified Research
- Form A-9A, "Is a Company a "Qualified High Technology Business" (QHTB) for Hawaii Income Tax Incentives?" (Question #1 from REQUEST FOR RULING)
    - QHTB Category of Company (from QHTB defined list)
    - % of company's activities that is "Qualified Research"
- Exhibit A from Draft of the desired ruling or determination (Item #5 from REQUEST FOR RULING)
    - JOBS
        - The number and type of the jobs created by the Company;
        - Permanent or temporary nature of jobs created
        - Total salaries and wages (by job classification)
    - EXPENDITURES
        - costs expected to be incurred
        - Description of Company's long-term business plans in Hawaii and elsewhere and benefits provided to Hawaii;
        - Other Tax incentives expected to claim

- INVESTMENTS
  - Total amount of investments expected from investors in first 12 months
  - List of information about each investor:
    - Name, address, SSN/FEIN of each investor
    - Amount, date of investment
    - Description of investment
    - What investor received in return for investment

DATA ALREADY COLLECTED FROM INVESTORS BY TAX DEPT.

- **N-318 (Required each calendar year)**
  - Name/SSN of Investor claiming credits
  - CREDITS
    - Name of QHTB & Dates of investments
    - Amounts of investments in each QHTB
    - Total amount of credits generated by investments made in submitting year
    - Amount of share if part of partnership
    - Amount of unused credits carried over from prior years
    - Total amount of credits claimable for submitting year
  - TAX LIABILITY
    - Amount/Type of liability
    - Other credits being claimed
    - Income Tax Liability
  - RECAPTURE DATA
    - Name/FEIN of QHTB
    - Amount of recapture
- **N-318A (Required each calendar year unless QHTB certificate received)**
  - Name/contact info of investor claiming credits
  - Name/ssn of QHTB
  - Amount of investment
  - Ratio of credit over amount invested (if more than proportionate share)
  - Amount of credit to be claimed over 5 year period
  - Name/FEIN of partnership (if applicable)

Testimony to the Tax Review Commission

October 25, 2006

By

Dr. Patrick K. Sullivan

My name is Patrick Sullivan and I founded Oceanit over 21 years ago with little more than $100. Today Oceanit employs over 100 people in the areas of aerospace, engineering, life sciences and information technology. In December 2001 Oceanit spun-out Hoana Medical, Inc., which is now selling its FDA approved product that improves patient safety into hospitals – we are saving lives. Hoana raised nearly $18mm in private equity in 3 rounds of financing and is closing a mezzanine round of approximately $20mm. Today Hoana employs approximately 40 people. In 2005 Oceanit also spun-out Nanopoint, Inc., an intracellular imaging company, that raised over $2mm in private equity financing and currently employs about 8 people.

To build a business in the technology industry you need ***people, ideas and capital***. Hawaii does well with the first two categories – great people and excellent ideas. However, we have historically done poorly in the area of capital. To add context, based on numbers a few years old, Hawaii's venture invested deals amounted to about $12.76 per capita. This is low compared to California, which invested $596.97 per capital, or Massachusetts' investment of $770.04 per capita or even war-torn Israel, which invested $37.76 per capita.

Although there is much confusion about how much and where capital has been invested, as well as how much has been actually invested into technology businesses, versus "other deals," Act 221 has added much needed capital into Hawaii's technology sector. It's difficult to measure the benefit; however, if we use somewhat dated venture investing numbers, for every dollar invested into a technology deal between 1970 to 1999, there was $9 in revenue generated in 2000. For each $21,627 of venture capital invested between 1970 to 1999, there was one job created in the year 2000. Nevertheless, since Act 221 investing started in 2001, there has been insufficient time to fully appreciate the benefits and ramifications to our economy in both return on investment and job creation. This should be no surprise, since venture capital funds typically last 10 years, where upper quartile funds can generate and internal rate of return to investors of 25%.

Act 221 capital is a type of "angel" or "seed" capital that does not replace the need for professionally run venture capital funds. Moreover, we are just beginning to develop a technology sector to Hawaii's economy and have created several excellent companies that may very well have not existed, except for Act 221/215. The State needs to take advantage of the momentum created from Act 221/215 and support the development of venture capital firms.

Nevertheless, since the local tech industry has benefited from tax-credits, I think it's entirely appropriate to direct State agencies, such as the Department of Taxation, to provide more detail on where the funds are going and what progress is being made toward developing a tech industry. Since qualified high technology businesses' (QHTB) are currently interpreted very broadly, directing the Department of Taxation to discriminate between technology investments and non-technology investments would be instructive. Additionally, since "we are what we measure," instructing the State to measure progress would also be very illuminating.

In summary, Act 221/215 investments are helping Hawaii develop a technology industry and should continue.

Attachment 9

Hawaii Angels

Reflections of Hawaii's 1st Formal Angel Network on Act 221/215

Robert J. Robinson

Hawaii Angels

- Launched February 2002 by Rob Robinson.
- 100 paid members on Oahu, Big Island and Maui.
- 12-person executive team, extensive screening.
- Approx. 1,000 deals screened since inception: 500 reviewed by executive committee, 150 presentations to full group, 34 companies received funding.
- Largely QHTB companies.
  - Includes Hoku Scientific, Hawaii Biotech, Hoana Medical, Hawaii SuperFerry, ClearFuels.
- Approx. $15M invested to date, $12M in QHTBs.
- 2 IPOs: Hoku Scientific (NASDAQ: HOKU) –Approx. 90-95% ROI, Napo Pharma (LSE: NAPL), 7/06.
- All companies operational.

Hawaii Angels

- Act 221/215 provides downside protection for investors who have traditionally put their money elsewhere.
- Hawaii Angels experience can probably be multiplied 10x for non-members.
- Absurd to frame this as "cost" to state: this is in fact the question.
- Many entrepreneurs will be happy to testify that they could not have started their companies without 215.
- Hawaii Angels investment and deal-sourcing process proven and well-suited to Hawaii's startup scene.

Attachment 10

HOKU Scientific®

October 18, 2006

To Whom It May Concern:

My name is Dustin Shindo and I am the Chairman and Chief Executive Officer of Hoku Scientific, a materials science company focused on clean energy technologies. My company, like many others in our state's tech industry, has benefited greatly from Act 221 and Act 215. I would like to offer my support of Act 221 and Act 215 and hope this successful program continues to flourish.

Hoku Scientific was started in 2001 to develop new fuel cell technologies. Since then, we have achieved many milestones, including our IPO in August 2005, and the purchase and build of our Kapolei facility. These advancements are due in part to the support of the State of Hawaii, through measures such as Act 221 and Act 215.

I urge you to reconsider findings from a study presented by the State of Hawaii Tax Review Commission on October 6, 2006 that seem to suggest a dwindling number of jobs in the technology sector and other negative conclusions about Act 221 and Act 215. As an active member of the technology industry, I can attest the number of employees at Hoku Scientific has increased several fold since the inception of the program in 2001. These new jobs are high quality positions that pay well and are meant for well educated candidates.

The greatest obstacle that technology companies face is the difficulty of raising venture capital in this state. However, once funded, technology companies in Hawaii can be very competitive globally. Any measure that will foster the development and growth in this area, including tax benefits or credits, is strongly supported by Hoku Scientific. Please do not hesitate to contact me should you have any questions or concerns. I can be reached via telephone at 682-7800 or email at dshindo@hokusci.com.

Best regards,

Dustin Shindo
Chairman and CEO

1075 Opakapaka Street • Kapolei, Hawaii 96707-1887 USA • Tel 808.682.7800 • Fax 808.682.7807 • www.hokuscientific.com

Attachment 11

DATE: October 25, 2006

TO: Mr. Isaac Choy
Chair, Tax Review Commission

FROM: Bill Spencer,
President, Hawaii Venture Capital Association

The Hawaii Venture Capital Association, founded in 1988, is one of Hawaii's oldest economic development organizations devoted to entrepreneurship and venture capital formation. We recognize the value of a careful review of policy initiatives that involve tax payer dollars. We believe that it is too soon in the life of Act 221/215 to attempt to analyze the cost/benefit effect of this program. Available data simply will not reflect the program's intended benefits. The companies that have been seeded in the last six years thanks to Act 221/215 are reaching a critical stage in their growth that will continue to require significant funding in order to achieve their potential for job creation and economic diversification. The investors in these companies must be allowed to continue to make investments without the threat of fundamental changes in the rules governing the program.

The Department of Taxation has all of the data necessary to do a thorough analysis of the facts of Act 221/215. However, it has never been given the mandate or resources to undertake such an analysis much less a true costs and benefits. We believe that this mandate must be forthcoming so that the department can publish data that can be used in order to decide whether the program should be continued beyond the sunset date on December 31, 2010. Any preliminary analysis would surely be premature given the length of time it takes for a start-up company to reach its full potential. In the meantime, we can confirm that Act 221/215 has created an environment in Hawaii that:

- Stimulates companies in sectors where Hawaii has particular strategic competitive advantage, such as the ocean, earth and life sciences
- develops companies that can export goods and services and help correct Hawaii's massive trade imbalance
- creates companies that can compete in the global marketplace
- creates more living wage jobs
- gives students opportunities beyond tourism service industry
- fosters a culture of entrepreneurship
- creates access to capital in Hawaii's rural and economically depressed areas
- rewards innovation and stimulates invention
- helps attract experienced business people, scientist and engineers to Hawaii
- attracts capital to Hawaii
- improves adult education and training opportunities
- enhances private sector research and development initiatives
- stimulates commercialization of research at our institutions of hiring learning

I do not believe any of the tax incentives passed by the legislature, that you elected not to review, have made this kind of contribution to Hawaii's business climate.

Mahalo for your consideration.

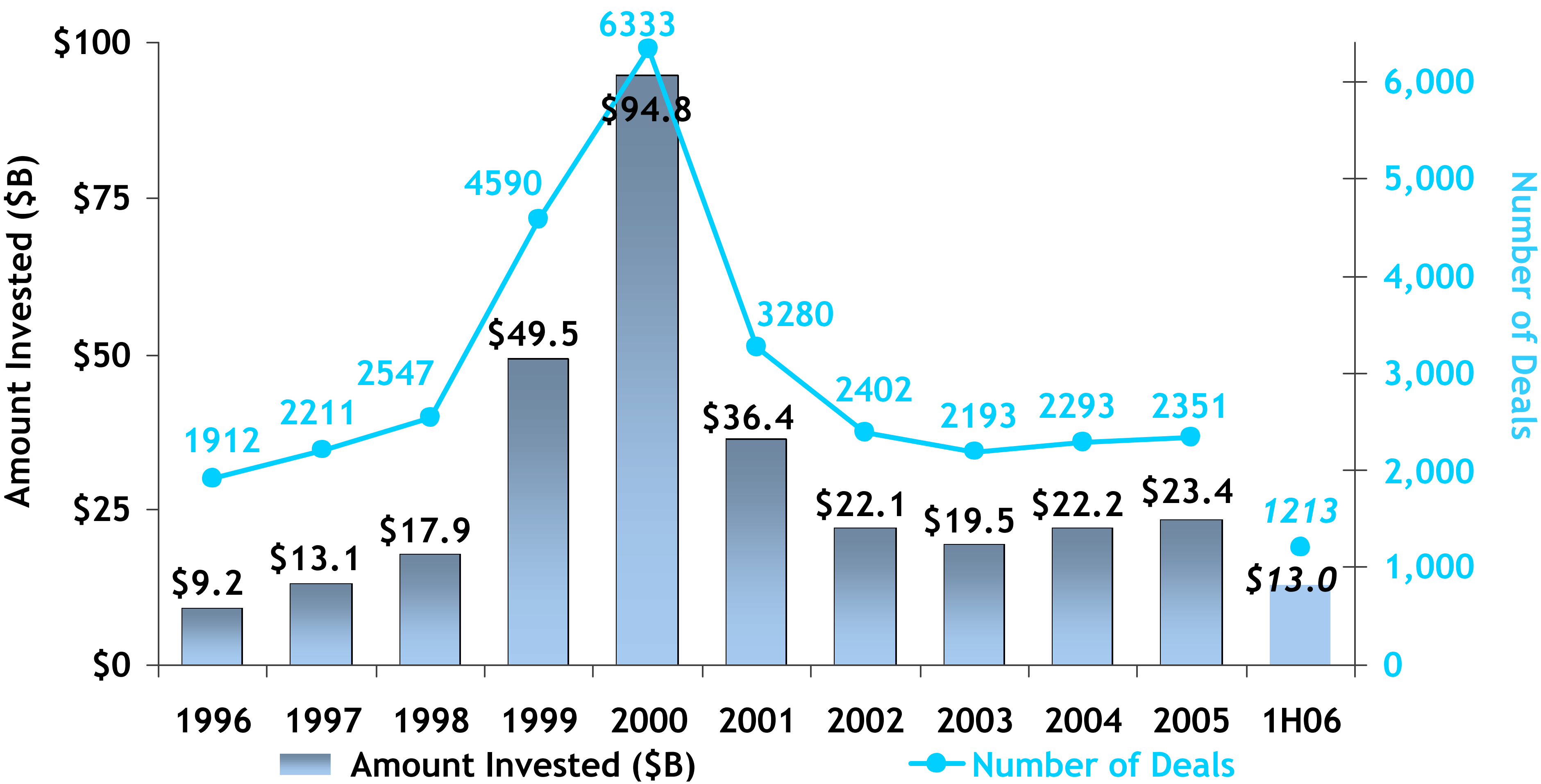
Attachment 12

Venture Capital Industry Overview

HAWAI'I
VENTURE
CAPITAL
ASSOCIATION

Total Mainland VC

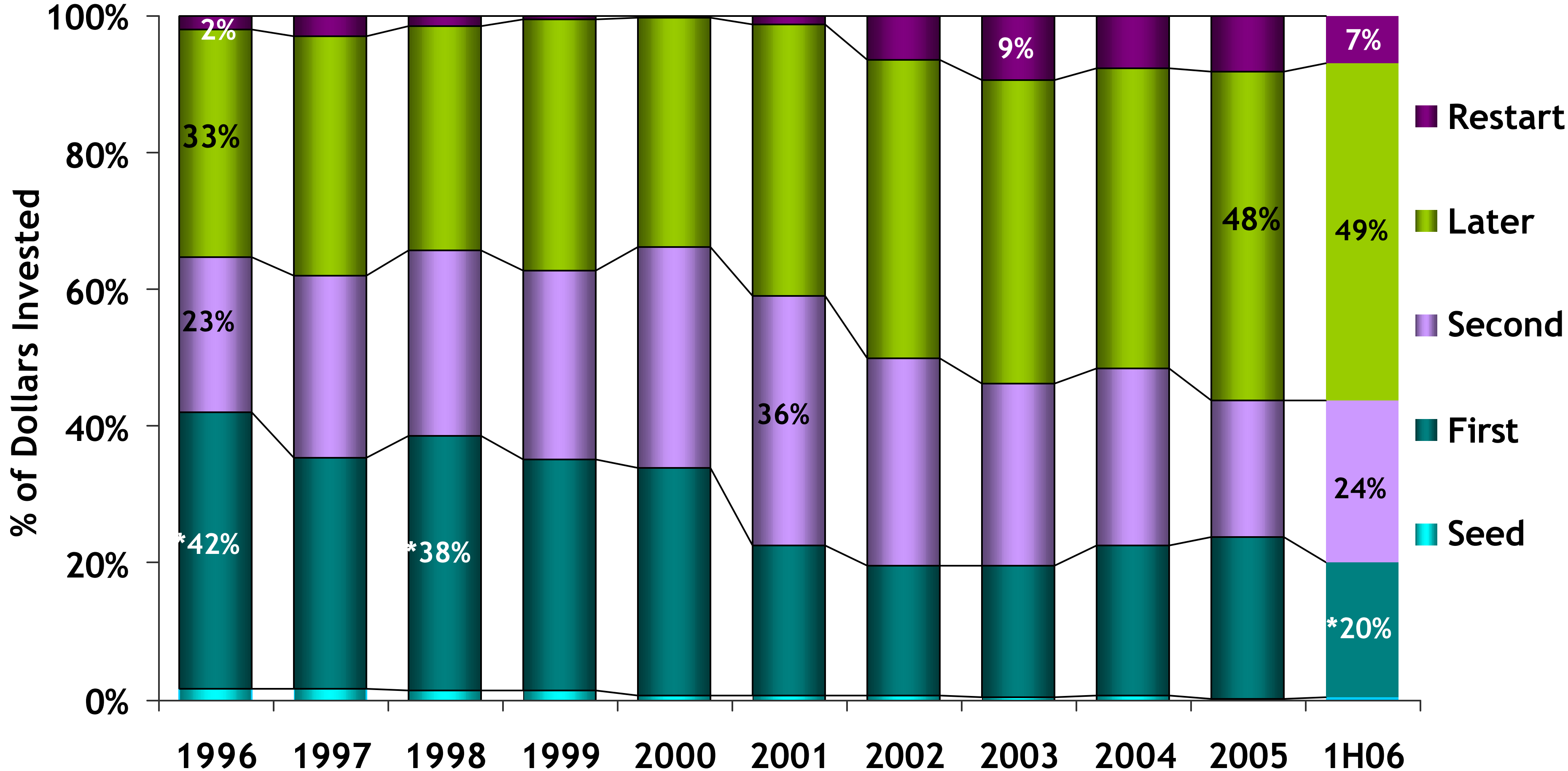
Deal Flow and Equity into Venture-Backed Companies



Source: Dow Jones VentureOne/Ernst &Young

More than ½ of Dollars Go To Later Rounds

Investment Allocation by Round Class (Annual)



*Seed and First Rounds Combined

Source: Dow Jones VentureOne/Ernst &Young

Hawaii vs. Mainland

- 2001-2004 Total VC - $100.2 Billion in 10,168 companies
- Investments in Hawaii - $185 Million in 200 companies
- Two tenths of one-percent of the total venture capital investment

Impact on Hawaii

- stimulates companies in sectors where Hawaii has strategic competitive advantage
- develops companies that can export goods and services to correct Hawaii’s massive trade imbalance
- creates companies that can compete in the global marketplace
- creates more living wage jobs

Impact on Hawaii

- gives students opportunities beyond tourism service industry
- fosters a culture of entrepreneurship
- provides capital to Hawaii’s rural and economically depressed areas
- rewards innovation and stimulates invention

Impact on Hawaii

- attracts experienced business people, scientist and engineers
- attracts outside capital into Hawaii
- improves adult education and training opportunities
- enhances private sector R&D
- prompts commercialization of R&D

Attachment 13

PACIFICAP
GROUP

PACIFICAP GROUP, LLC
841 Bishop Street, Suite 1020
Honolulu, HI 96813
Direct: 808.237-5388 Fax: 808.537-2188

October 25, 2006

Tax Review Commission
State of Hawaii
Attention: Mr. Issac Choy, Chairman

Re: Analysis of Act 221/215 High Technology Business Investment Tax Credit (Section 235-110.9, Hawaii Revised Statutes)

Dear Mr. Choy,

Thank you for the opportunity to submit testimony and analysis of the Act 221/215 High Technology Business Investment Tax Credit (the "Investment Credit") and the draft Study dated October 2, 2006 (the "Study") submitted to the Tax Review Commission (the "Commission") by Professors Bruce Bird and Marcia Sakai.

My name is Jeffrey Au. I am Managing Director and General Counsel of PacifiCap Group, Hawaii's largest locally based venture capital firm. Our affiliate venture capital funds have invested in more than $25 million in more than a dozen Act 221/215 Qualified High Technology Businesses ("QHTB's") to date.

In the interest of full disclosure, Ted Liu, the current Director of the Department of Business Economic Development and Tourism ("DBEDT") was a partner of PacifiCap prior to his joining the Lingle Administration in early 2003.

Beyond my professional activities as a venture capitalist and practicing attorney, my personal and academic interests in issues of capital formation and economic development long precede the existence of Act 221. Prior to attending law school, I obtained a master's degree in International Policy Studies from Stanford University, where the primary focus of my studies and research was on the economic development impact of foreign direct investment in less developed countries. Of particular interest were successful models of rapid economic growth and diversification in Asia, which were based upon hybrid models of market forces combined with government incentives to promote economic diversification, local capital formation and technology transfer. These successful hybrid models in countries like Taiwan, Singapore, Japan and South Korea compared to the failures of pure "free market" strategies pursued in regions such as Latin America and Africa that were justified on theories of "economic efficiency" and "comparative advantage," but which in reality often led to boom/bust "banana republic" models of economic growth without diversification, in which the rich got richer and the poor got poorer, and which over the longer term has proved to be unsustainable.

As a fourth generation *kamaaina*, the impact that these problems of economic diversification and local capital formation have on our local community here in Hawaii have always remained very close to my heart. My views are expressed in more detail in the editorial attached hereto as <u>Exhibit A</u> that I co-authored, which was published in the *Honolulu Advertiser* on May 6, 2001, almost two months before Act 221 became law.

As your Commission moves forward in reviewing the Act 221 Investment Credit, I urge you to remain cognizant of the profound impact that your recommendations could have, for better, or for worse, on the long-term economic life of the community that we all cherish. I ask you to rise above the politics and to look beyond the negative press spin and PR campaigns that have plagued this issue for so many years. I urge you to consider that the vision and leadership that you demonstrate today, in either promoting or impeding Hawaii's structural economic transformation into high technology and higher value added industry sectors, could have as profound an impact on the economic opportunity and social mobility of Hawaii's future generations, as the vision and courage demonstrated by our grandparents and great-grandparents, in structurally transforming Hawaii from a plantation economy of sugar and pineapple, into a more diversified, vibrant economy of tourism, services and small businesses with local ownership.

The following are highlights of issues that I respectfully suggest the Commission consider in evaluating the costs and benefits of the Act 221/215 Investment Credit:

I. <u>Data Analysis</u>

Before one can rationally evaluate the costs and benefits of the Act 221 Investment Credit based upon available data, one must first establish relevant, consistent and coherent analytical paradigms for evaluating these data. Data must be analyzed within the proper context of the specific legislative intent of relevant laws, policy objectives, as well as the proper context of relevant industry sectors and conditions.

Empirical Data vs. Press Spin: From reading the papers, as recently as yesterday (see Exhibit B), we all know that Act 221 has at times become controversial. However, much of this controversy seems to be spun up from a repeated pattern of press articles citing conflicting, contradictory, inaccurate and misleading data. The press is not necessarily to blame, since we all know the first rule of empirical data research and reporting is **"Garbage In, Garbage Out."** Your Legislative mandate, as members of the Tax Review Commission, is not simply to analyze and interpret the Garbage. Your role is to separate the Garbage from the empirical facts, and to figure out where the Garbage is coming from, and why. Consider the following highlights:

- **$1 Billion Headlines**: Yesterday's front page *Honolulu Advertiser* headline reads, "Tech tax credits could cost $1B," presumably based upon a report to the State Council on Revenues by the Department of Taxation. Where is this report, and why has it not been disclosed to the Tax Review Commission, industry representatives or the general public? When was this Council on Revenues meeting held, and when was this report was submitted? Was it before or after the previous Tax Review Commission meeting held in this room less than two and a half weeks ago on October 6, 2006, when Tax Director Kurt Kawafuchi personally stated to all of us that data was not yet available for 2004 and 2005? What are the empirical and theoretical assumptions substantiating this report and its $1 Billion estimate? Can we at least see a copy of this report now? If this $1 Billion estimate was preliminary and illegally leaked from confidential Council on Revenue proceedings, why and how was it leaked, and by whom? Should the Council on Revenues, the Tax Review Commission and/or the Governor be calling for an Attorney General investigation of if there was an illegal or improper leak and whether there **was any deliberate intent to mislead the press and the public?** How is it that it can take more than <u>three years</u> for us to get data from **2003**, but less than <u>three weeks</u> to get data for **2004**, less than <u>three days</u> to get data for **2005** (with the 2005 extended tax filing deadline being last Friday, October 20, 2006), while at the same time, we can get data for **2010** more than <u>four years ahead of time</u>?

- **Conflicting Credit Data:** Once again, on the front page of yesterday's *Advertiser*, we see data reported that directly contradicts the primary source data reported by the Department of Taxation. For example, for 2003, the *Advertiser* article reports $74.5 million in Tax Credits claimed, but primary source data from the Department of Taxation reported on Table 1 of the Bird/Sakai Study (attached as Exhibit C) reports only $38.87 million, **reflecting a discrepancy of $35.63 million, or more than 91%.** The $1 Billion estimate **overstates** even the Bird/Sakai estimate of $600 million over ten years **by $400 million, a discrepancy of more than 66%.**

- **Conflicting Jobs Data from DBEDT:** The technology jobs data from DBEDT reported on the front page of yesterday's *Advertiser* concludes that technology jobs in Hawaii "only rose by 350 jobs since 2001." Once again, these DBEDT jobs data are burying the **significant increases of Act 221 sector technology jobs** by combining and **mixing them up with** substantial **job losses from NON-ACT 221 TECHNOLOGY JOB SECTORS.** These discrepancies were discussed in two separate editorials recently published in each of the *Honolulu Advertiser* and *Honolulu Star-Bulletin*. Page 31 of the Bird/Sakai Study reports that based upon primary source Tax Department data, **4,189 jobs were created by Act 221 companies in 2002 and 2003 alone.** This reflects a **discrepancy of 3,839, or more than 1196% from the 350 DBEDT number reported yesterday.** Interestingly, another DBEDT report dated October 2006 and attached hereto as <u>Exhibit D</u> concluded that, ***"R&D activity has been the strongest component of Hawaii's private tech sector, with a 36% increase in jobs from 2001 to 2005—nearly 4 times faster than all private sector job growth."*** Unfortunately, this DBEDT data **did not make it to the front page** of yesterday's paper. The same DBEDT study also reports that between 2001 and 2004, there were **significant job losses** in a segment of the "Technology Services" **sector not covered by Act 221**, with **job losses *"primarily centered in the communications industry which lost nearly 1,200 jobs over that three year period."*** With respect to tech manufacturing (also a **NON-ACT 221** job sector), the same DBEDT report concludes, ***"the job count declined by nearly 40% from 2001 to 2004. Most of that loss is likely due to the relocation of one large firm's manufacturing operations to the Mainland in 2002."***

Unfortunately, **negative press spin and conflicting data** and reports on Act 221 is nothing new. It has been a **recurring pattern** that has plagued Act 221 press reports for many years. Consider the following:

- **2003 Front Page Credit Discrepancy:** On March 13, 2003, the *Advertiser* ran the Front Page story attached as Exhibit E, reporting ***"an estimated $46 million in tax breaks under the state's technology investment tax credit in its first year, nearly three times as much as had been estimated. . ."*** However, primary source Tax Department data reported on Table 1 of the Bird/Sakai Study shows **only $30.79 million invested** in 2001, representing **a 49.4% discrepancy.**

- **2003 Study Finds Tech Growth Slowed??**: We have also seen press spin trying to convince the public that Act 221 Investment Credits have actually REDUCED tech jobs in Hawaii before. On April 18, 2003, the *Honolulu Advertiser* ran the article attached as Exhibit F, reporting that ***"Hawai'i's fledgling high-tech sector grew at a slower rate in 2001 - the first year of the state-granted Act 221 tax credits to encourage investment and research in technology, according to information released by the office of Gov. Linda Lingle yesterday."*** According to Tax Director Kawafuchi, ***"What it tells me is we increased the size of the tax credits by 10 times for a decline in the percentage growth of the industry."*** Governor Lingle even commented on this one, stating that lawmakers ***"don't need to be worrying about saving face on this issue. They need to worry about saving Act 221."*** All of this was reported ***"weeks after the Council on Revenues blamed the incentives rather than the economy for lower-than-expected tax collections in the current fiscal year."*** All of this of course, was before the Council on Revenues knew that it would have **more than a $700 million budget surplus**, without any restrictions to Act 221, and apparently before DBEDT chose to release the job analysis data cited above to either the Governor or the Council on Revenues.

- **2003 Full Scale Public Opinion Campaign**: On April 22, 2003, the *Honolulu Star-Bulletin* reported that ***"the Lingle administration has mounted a full-scale public opinion campaign to cut back the tax benefits of Act 221."*** The Governor's news conference ***"came after a highly critical release from the Tax Department issued Saturday said tax credits were causing tax revenues 'to plummet.'"***

  So the press spin on Act 221 tax credits that we read on the front page of yesterday's *Advertiser* is nothing new. Unfortunately, it is not an isolated incident, but a recurring pattern and a rerun of what we saw in 2003. Critics of Act 221 appear to want our community to believe that Act 221 Investment Credits cost the State more than they actually do, and that these credits DECREASE RATHER THAN INCREASE tech jobs in Hawaii. Moreover, they try to use DBEDT, the Department of Taxation, the Office of the Governor and an institution as important as the Council on Revenues to legitimate positions that have dubious factual substantiation. Hopefully, the Tax Review Commission will be able to preserve its integrity and independence from these efforts.

  So how should the Tax Review Commission respond to this information?

  I guess the best I can suggest is the advice that my father taught me at a very young age many years ago: **"The First Time, Shame on Them. The Second Time, Shame on You."**

So if misleading press spin is not the right way to evaluate the Act 221 Investment Credit, what is?

Primary Source Data: It is critical that primary source data from the Department of Taxation be used for any analysis. **These data are already available to the Department of Taxation** as taxpayers cannot claim Investment Credits in the first instance without reporting to DoTax how much cash they invested in QHTB's. Additional data, such as job creation, also must be reported to DoTax by QHTB's, under penalty of perjury, on Form N-317. DoTax has already released aggregate data on a no-names basis from these filings (as is included on Tables 1 and 2 of the Study), and it can continue to do so. It is not necessary to breach well established federal and state laws and principles of taxpayer confidentiality in order to analyze these data. What is relevant for serious policy makers is data on HOW MUCH was invested—not on WHO invested it.

The Commission should also take seriously the advice of Mr. David Brunori, contributing editor for the tax policy magazine, *State Tax Notes* in Washington, D.C., as reported by the *Honolulu Advertiser*:

> (Confidentiality of returns) is a very important concept in the American tax system both at the federal and state level. . . Without it, the system would collapse. Virtually every state and federal law has very, very strict positions about (what constitutes) disclosure of tax return information—that is anything that would allow a third party to identify a taxpayer's identity or any financial information.

Primary source data appropriately aggregated and segmented as necessary to protect confidentiality, obtained from official Tax Department filings, are the only legitimate sources of data for purposes of rigorous analysis of the Investment Credit. They are reported by taxpayers under penalty of perjury, and if they are not filed, no Investment Credits may be claimed, thus resulting in no cost to the State. They can and should be reported to the public, but only on an aggregated no names basis without breaching very important, widely accepted principles of taxpayer confidentiality.

Any other survey or data collected by other government agencies, industry representatives or other third parties, is likely to be incomplete, as many investors and QHTB's may not be surveyed or may not respond. Moreover, the accuracy of such other responses cannot not be assured under penalty of perjury, and confidentiality for respondents cannot be assured. As discussed below, data provided by other State agencies such as DBEDT may also be problematic to the extent that they introduce additional conflicting and extraneous data unrelated to Act 221 that confuse, rather than clarify the relevant analysis.

Capital Formation: Cost/Benefit vs. Cost/Cost Analysis: The data used to evaluate the costs and benefits of the Investment Credit must be directly tied to the specific statutory and policy objectives of the Investment Credit itself, which grants Investment Credits to taxpayers for investing cash into Qualified High Technology Businesses ("QHTB's"). Any legitimate analysis must measure not only the costs of the Investment Credit in terms of reduced tax revenues, but also the benefits in terms of cash invested in QHTB's. It is misleading to only report the cost to state revenues from Investment Credits earned, without at the same time reporting the amount of investment made into QHTB's as a result of those Investment Credits. As is discussed in more detail below, because the 100% Investment Credit, as a matter of law, is earned over a five year period after a QHTB investment is made, the amount of **Investment Credits** earned **ALWAYS** will be **EQUAL TO OR LESS THAN** the amount of **cash invested** during the five year period. When taking into account the time value of money, the value of the Investment Credits earned with still be less than the value of cash invested, even after the expiration of the five year period. It should also be noted that many QHTB's may not survive the entire five year period, thus triggering recapture of 10% of the two prior years' Investment Credits and eliminating Investment Credits for the current and future years. To survive five years, most QHTB's will also need to secure additional investment capital in subsequent years, unless they are successful in generating sufficient revenues to fund operations.

The foregoing analysis appears to be substantiated by Tax Department data reported in Table 1 of the Study, which shows $185.08 million invested in QHTB's from 2000 through 2003, and only $75.03 million in Investment Credits claimed through 2003.

Job Creation. If one wants to measure the impact of the Act 221 Investment Credit on job creation, one must focus on jobs created in industry sectors to which the Act 221 Investment Credit actually applies. **Including extraneous data from DBEDT from non-Act 221 industry sectors to conclude that technology jobs declined as a result of the Investment Credit**, as was done by the Study, rather than relying on primary source data from the Department of Taxation that shows significant job increases in sectors actually covered by the Act 221 Investment Credit, can be **misleading from both an analytical and public policy standpoint.**

Unverified data publicly **reported by DBEDT** that **directly contradict** primary source Tax **Department data**, also raise serious concerns. For example, DBEDT **Director Ted Liu reported** in the attached April 1, 2004 *Honolulu Advertiser* article an estimated **600 to 800 new technology jobs in 2002.** From these numbers, Director Liu concluded that the costs of Act 221 for job creation was "still higher then the estimated $90,000 of investment needed to create one job in California's Silicon Valley." He added that "The data has holes in it," but that "we thought we were within the range of credibility." Primary source **data from the Department of Taxation**, however, **shows creation of 1,980 QHTB jobs** reported in 2002, reflecting an apparent **underestimation by DBEDT of up to 69% percent.**

The Commission should further examine the level of accuracy of Act 221 data that has been reported to the press and public by State officials to date, and why. Tax Director Kawafuchi was also interviewed and directly quoted in the same April 1, 2004 *Advertiser* article cited above. Why couldn't the article or Mr. Liu at least alert the public to the discrepancies between the primary source data obtained by the Department of Taxation and the lower job creation numbers reported by DBEDT for 2002? From where did DBEDT get its numbers on Act 221 tax credits? Can these sources be verified? If not from the Tax Department, what other reliable source could there be? Whatever the source, should State officials feel an obligation to explain and alert the press and the public to an apparent statistical discrepancy as large as 69%?

It should also be noted that the **initial job creation data** reported for the Act 221 Investment Credit **may underestimate the actual job creation potential** of the Investment Credit due to a variety of factors. For example: A) Tech companies that create **higher paying jobs create FEWER jobs for the same amount of money** (e.g., $100,000 could pay for 5 hotel maids or just one senior software engineer). The legislative intent of Act 221 was to create higher paying jobs, and not a higher number of low paying jobs; B) Particularly in a market like Hawaii that has very little venture capital, young companies conducting research before having revenues must keep their "burn rates" and salary levels to a minimum until they have product to sell and sufficient revenues to pay for more salary and operating costs. **Creating a lot of jobs before a company has product to sell and other revenues is a recipe for bankruptcy** and should not be encouraged by the State government. C) Many small companies use **"employee leasing companies"** to minimize administrative paperwork. The jobs they create may not be reflected in direct employee numbers. D) Both tech companies and TV and film production companies often use **independent contractors** rather than employees to filling staffing positions. A production company that spends tens of millions of dollars in Hawaii on very large production crews may have very few employees. Independent contractors and vendors of QHTB's therefore need to be included in an accurate job creation analysis. E) Many **founders and employees** of early stage tech companies **often take below market or even no cash salary**, typically in exchange for founders' stock, stock options or other equity compensation. I would guess that Hewlett and Packard did not draw very large salaries from that company started in that famous garage in Palo Alto many years ago. If companies like this that create no jobs up front are funded as a result of Act 221, is this a bad thing from a policy standpoint?

II. Statutory Analysis:

A responsible analysis of the Act 221 Investment Credit must be based upon what the law actually allows under its specific statutory provisions. Hypothetical scenarios of what "might happen" that misinterpret or ignore what the law actually says serve to confuse, rather than clarify, the issues.

100% Credit? One of the biggest misconceptions about Act 221 is that it guaranties investors a 100% tax credit.[1] This is simply not true. Act 221 provides investors with the *potential* to receive state tax credits equal to 100% of their investment amount over five years, but only if a company survives and maintains its QHTB status for the five year period. As a general rule, many new companies fail within two or three years of formation, and many technology companies cannot survive more than just one year without investors investing more cash into them. Venture capitalists typically fund young technology companies nine to twelve months at a time, so there is substantial risk that a company may not survive for even one year, much less five. Unproven technologies and high "burn rates" can further increase survival risks. Experienced investors and entrepreneurs know that these risks do not necessarily imply "bad deals." They are inherent to early stage technology investing. To just survive five years, a young technology company must "beat the odds." Receiving 100% in credits over five years, therefore, is by no means a "sure thing." Moreover, if a company fails, or another recapture event occurs, 10% of the Investment Tax Credits received for the two preceding tax years will be recaptured.[2]

Federal and State Taxation of Credits. Investors experienced with tax law also understand that the economic value of even 100% in state tax credits is in reality worth much less than it sounds. The economic value of Act 221's Investment Tax Credits can be reduced by more than 40% due to the loss of federal and state deductions for state tax (in addition to a discount that should be applied for the time value of money over the five year period). Assuming federal and state tax rates of 35% and 8.5%, respectively, for a combined rate of 43.5%, the after tax value of a 100% Investment Tax Credit to an investor would be only 56.5% over five years, or 19.8%, 14.1%, 11.3%, 5.6% and 5.6% in years one through five, respectively.[3] It should be noted that the reduced state deduction for state tax simply lowers the credit value for investors and "gives back" a portion of the credits back to the state. It should be noted that high net worth individuals who are subject to the Alternative Minimum Tax ("AMT") may not be eligible to deduct state tax from federal and state taxable income in the first instance.

NOT A Tax Shelter--Investment Amounts Must Far Exceed Tax Credits. Because investors must invest 100% of their investment amount while receiving only a 35% credit in the first year, an extra $65 of private capital investment is attracted for every $35 of credits initially granted. Act 221 therefore requires investors to make initial cash expenditures that are substantially greater than their tax liabilities alone. Even if 100% in Investment Credits are earned over five years, the value of these

[1] See, e.g., Duchemin, John, "Controversy still dogs Act 221 on last day for 2002 investments," *The Honolulu Advertiser*, December 31, 2002, B-1.
[2] Section 235-110.9(d), HRS.
[3] These numbers are provided for illustration purposes only. Actual tax rates and impacts on federal and state deductions varies among taxpayers depending upon their specific circumstances and tax status.

credits will less than the value of cash invested up front due to the time value of money. As a whole, investors cannot avoid losing money without substantial equity returns. Consider the following:

- **Must Invest More than 285% of Initial Tax Liability.** Assume that Hawaii taxpayers wants sufficient Investment Tax Credits to offset $35,000 in Hawaii tax liability. To do so, the taxpayers (and/or their co-investors) must invest a total of $100,000 in a QHTB, or more than 285% of their initial tax liability. If one assumes additional federal and state tax on the credits at a combined rate conservatively estimated at 40%, the taxpayers would incur additional tax liability of $14,000, for total cash expenditures of $114,000, or more than 325% of the initial Investment Credit amount. As discussed above, in order for a QHTB to survive for five years, it is very likely that investors will have to invest even more cash prior to the time that the QHTB has sufficient revenues to cover operating costs.

- **Without Equity Returns, Investors Lose Money.** Even if a company maintains its QHTB status for five years, without equity returns, the total "cost" to investors of $100,000 in state credits over five years would be the $100,000 in investment and about $40,000 in additional federal and state tax on the credits, for total costs of $140,000. Obviously, without equity returns, the opportunity to lose an extra $40,000 over five years if all goes well (and to lose more if things do not go well) is not an attractive proposition to any taxpayer.

III. Economic Analysis:

- **Tax Credits are Targeted Tax CUTS, NOT Government Spending:** The Bird/Sakai Study seems to confuse a very basic economic principle. It suggests that the Act 221 Investment Credit is a form of government spending. To the contrary, tax credits are, by definition, TAX CUTS that REDUCE (presumably less efficient) government spending. Act 221 Investment Credits allow taxpayers to keep their state tax money in the private sector, to invest it into Hawaii technology companies. With a maximum 35% credit earned in the first year, investors as a whole must invest in the first year more than 285% of their state tax liability. Tax credits and general fund dollars actually have the *opposite* effect on the private sector. Tax credits, by definition REDUCE taxes paid by the private sector, while general fund government spending INCREASES the tax burden on the private sector. The fundamental economic development question is whether growth multipliers and capital deployment are higher and more efficient through private sector investment or government spending through higher levels of taxation. To grow Hawaii's economy, is it better to reduce taxes to stimulate private investment driven by market forces, or is it more efficient to increase taxes to allow more of the state's capital to be deployed by administrative state agencies (such as DBEDT). Would it be better policy to abolish Act 221 and give $1 billion to DBEDT to administer?

- **Targeted Credits More Efficient Than Across the Board Tax Cuts:** In terms of tax relief, the only alternative to targeted tax incentives are across the board tax cuts, which are much more costly, with fewer results. The 1998 income tax rate reduction, for example, is estimated to cost more than $750 million in state tax revenues over 4 years, which is more than 3 times as much of the projected costs of Act 221 Investment Credits. It is unclear how much economic diversification and investment growth resulted from the 1998 income tax reduction.[4] One must also note that

[4] Kamikawa, Ray, "Response to Tax Review Commission Report, Twenty-Second Legislature (2003)," February 13, 2003.

unlike Act 221 Investment Credits, which requires taxpayers to invest their tax savings into Hawaii technology companies, across the board tax cuts allow taxpayers to spend or invest their tax savings outside of Hawaii.

- **Immediate and Long Term Benefits to the State?** Longer-term benefits of economic diversification, by definition, cannot be immediately measured. But this does not mean that the goal of economic diversification should not be pursued. The short-term benefits of the Investment Tax Credits, are both immediate and measurable. As discussed below, the Investment Tax Credit creates an immediate and measurable increase to gross state product. In the year of investment, $100 must be invested for every $35 of credits granted, for an immediate net increase to gross state product of $65. Additional credits, if received in the subsequent four years, will in the aggregate have lesser value than the investment amount, due to the time value of money. Over the longer term, if one assumes that capital can be more efficiently deployed by investment through the private sector than through government spending, then higher growth multipliers should apply to private investment over government spending. The Investment Tax Credit would thus imply much higher long-term growth to GSP and the state's economy than if more tax revenues had been raised and simply spent by the government.

- **Immediate and Longer-Term Increases to Gross State Product:** Assuming the standard macroeconomic formula Y=C+I+G+X-M, where Y is gross state product, C is consumption, I is investment, G is government spending, X is exports and M is imports, if investment (I) is increased by $100,000, at a cost to tax revenues and government spending (G) of $35,000 due to the Investment Tax Credit, there is an immediate net increase to gross state product (Y) of $65,000. Even if tax revenues of $100,000 are lost over five years due to the Investment Tax Credit, because of the time value of money, the net present value of this credit paid over five years is much less than the $100,000 GSP (Y) increase resulting from the initial investment (I) attracted from the private sector. To the extent that investment (I) yields a higher "multiplier effect" than government spending (G), gross state product (Y) will be further increased over time. Increased exports (X) by QHTB's and import (M) substitution from the products they make, will further increase gross state product (Y). Put simply, if investors must invest up front almost three times the initial tax credit received, gross state product, by definition, will immediately increase. If one assumes that private sector investment will yield higher multiple returns than government spending, with the added potential to increase exports and decrease imports, Act 221's Investment Tax Credits should grow the state's economy, both in the immediate and longer term.

IV. Recommendations:

So where should we go from here? What should we learn from our past to improve our prospects for the future? I respectfully suggest consideration of the following recommendations:

- **Rely Exclusively on Primary Source Data:** All analysis of Act 221 Investment Credits should be based exclusively on primary source data, currently held by the Department of Taxation, from Forms N-317 and N318 filed with the Department by taxpayers under penalty of perjury. Extraneous data from DBEDT or any other source, and misleading press reports that serve to confuse, rather than clarify the costs and benefits of Act 221 should be excluded from any analysis. Existing data should be reported on an aggregated basis to preserve taxpayer confidentiality, in a consistent format, on a consistent schedule, established with input from industry.

- **Stop the Negative Press Spin**: Our State officials should be using their time and State resources on supporting our local technology companies rather than on trying to make Act 221 look bad in the press. Their time and our taxpayer dollars would be better spent trying to raise Hawaii's grade of "F" for business environment cited in the Bird/Sakai study.

- **Exclusive Administration of Act 221/215 by the Department of Taxation**: The Department of Taxation and the conscientious professionals who staff it should be allowed to fulfill their legislative mandate to administer, enforce and report on Act 221/215 with professional independence and without political interference. There should be **ZERO TOLERANCE** for political interference from outside of the Department of Taxation, whether from DBEDT, the Office of the Governor's Chief Policy Advisor, the Press Office or anyone else, with respect to all Act 221/215 administration, enforcement and reporting, including the issuances of comfort letter rulings, the drafting of administrative rules and policies, and the reporting of Act 221/215 investment and job creation data to the Council on Revenues, the press and the public.

Thank you very much for giving me the opportunity to testify before your commission today.

Respectfully submitted,

Jeffrey K. D. Au
Managing Director and General Counsel
PacifiCap Group, LLC

LT102506Act221AnalysisTaxReviewCommission

Exhibit A

HonoluluAdvertiser.com

Posted on: Sunday, May 6, 2001

Hawai'i represents what the ADB is fighting for

- ADB accused of reckless development
- ADB making difference in Pacific
- Cool heads can make a difference in bank meeting
- Advertiser special: ADB in Hawai'i — global issues, local impact

The dawn of the new millennium brings both excitement and apprehension to our Aloha State.

The pace of innovation accelerates with advances in information technology, communication, and biotechnology. We must ask ourselves whether these developments present unprecedented opportunities for Hawai'i's economy to leap forward, or mean that we will fall behind the rest of the world.

Visitors such as Chicago residents Renee Fields (left), Kathy Harding and Terri Redden often take Hawai'i's beauty home with them in the form of photographs. Yet, as the ADB meeting suggests, Hawai'i can offer much more than packaged tourism and a momentary photo-op.

Advertiser library photo • Feb. 13, 2001

We welcome the annual meeting of the Asian Development Bank. But just as we start to realize the decades-long dream of making Hawai'i the "Geneva of the Pacific," we are troubled by allegations that ADB programs exacerbate poverty and economic inequality and fail to lift up Asia's disenfranchised underclass.

For the Asian Development Bank, Hawai'i offers more than nice weather and a beautiful venue. We offer a successful model of political-economic development virtually unmatched anywhere in the Asia-Pacific region. Hawai'i has avoided the gross income inequalities associated with the Philippines, Indonesia and Thailand. It has been able to achieve its levels of economic growth without the limits on political expression associated with Korea, Singapore, China or Taiwan, and without the second-class citizenship imposed for almost a century on the Chinese people of Hong Kong.

Sustained growth, equitable income distribution, social mobility and racial equality, all without a legacy of political repression, are the fundamental ideals of the Asian Development Bank. However, these ideals have remained elusive throughout the region, except for in Hawai'i.

Hawai'i also has realized American ideals to a greater degree than most of the United States. At the dawn of the 21st century, we still read about race riots in Cincinnati and recent polls finding that one in four Americans hold "very negative attitudes" toward Americans of Chinese ancestry. While problems of poverty remain in Hawai'i, they are nowhere near the orders of magnitude of intractable inner-city poverty that plagues most major American cities. Only in Hawai'i is multi-ethnic representation pervasive throughout all levels of business, government, labor and academia.

The socio-economic ideals that Hawai'i has achieved over the past half century have resulted from democratic representation, not only in the political sense, but in the economic arena as well. Local capital accumulation, reinvestment and entrepreneurialism across racial and socio-economic lines have fostered the growth of local businesses, a vibrant middle class and key decision-makers coming from all sectors of our community. However, with increasing opportunities to invest, work and live outside of the state, we increasingly see the financial and human capital that was so critical in building the community we cherish leaving Hawai'i for higher short-term returns and compensation.

We watch with pride and hope as our sons and daughters of Hawai'i excel educationally and professionally in national and international arenas. But we worry how much longer it will be before they and their children no longer consider Hawai'i to be "home."

The uncertainties we face today are real, with no easy solutions. But we are not without hope. In searching for a coherent vision for our future, we can find hope and inspiration by reconnecting with our past.

If there is a lesson to be learned from the successful economic development models of Hawai'i and Asia, it is the importance of economic diversification, local capital accumulation and reinvestment.

Economists and portfolio managers emphasize theories of "efficient markets," the need to maximize portfolio returns in the short term and the "economic rationality" of investing our capital outside of Hawai'i. However, such portfolio and asset allocation models fail to reflect the broader economic impact that local reinvestment has on longer-term structural economic development. With their emphasis on the "free mobility of capital," traditional economic theories fail to consider the immobility of community, culture and climate — Hawai'i's most valuable assets.

Where would Hawai'i be today if we had strictly adhered to the principles of "comparative advantage," pouring all of our resources into pineapple and sugar cane without diversification into tourism and services? And where will Hawai'i be if we fail to further diversify our economy into high technology and higher value-added industries?

Hawai'i today does not lack investment capital. What we lack is the vision and commitment to invest and re-invest locally in our own future. The capital needs of Hawai'i's emerging growth companies are small relative to the local financial resources potentially available. In addition to financial capital, Hawai'i is rich in potential intellectual and human capital. For decades, hundreds of Hawai'i's children have excelled at top Mainland universities. The challenge facing Hawai'i's leaders is to develop and implement compelling vehicles and strategies to attract existing resources back home.

Structural transformation is never easy. However, Hawai'i's successful transformation from agriculture to tourism proves that it is possible. Moreover, the successes of Hawai'i's prior generations can serve as an inspiration to us today.

We have an obligation to perpetuate the often elusive but precious gifts of economic opportunity, social mobility and racial harmony that our parents and grandparents struggled so hard to pass on to us.

What is at stake is much more than provincial pride or sentimentality. What is at stake is proving to the world's skeptics that socioeconomic ideals have been, and can be achieved. We must work together, for there is much to gain.

If we fail, there is far too much for all of us to lose.

Jeffrey Au is managing director of PacifiCap Group; Joseph F. Blanco, technology development special adviser, Office of the Governor; Tareq Hoque, resident, SPIRENT Communications' ad-tech division; Randolph Moore, president/CEO, Kane'ohe Ranch; Anthony Rutledge, president/CEO, Unity House; and Lily Yao is a community and business leader.

Back

50 YEARS

The Honolulu Advertiser

HAWAI'I'S NEWSPAPER

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Tech tax credits could cost $1B

Revenue report raises question about benefits of 10-year program

BY SEAN HAO
Advertiser Staff Writer

Hawai'i's tax credits for technology investment are likely to cost up to $1 billion in foregone revenues, but it's difficult to say if the state is getting that much in return.

The state tax department reported the $1 billion figure — enough money to pay for one-third of O'ahu's proposed mass transit rail system — at a recent meeting of the state Council on Revenues.

It was the first time the state publicly speculated on how much the credits, implemented in 2001, could cost during their planned 10-year life span.

The Act 215/221 credits were

SEE CREDITS, A5

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HAWAI'I TECHNOLOGY SNAPSHOT

TECHNOLOGY JOBS

The number of technology jobs in Hawai'i jumped by 700 jobs in 2005, but only rose by 350 jobs since 2001.

YEAR	TECH JOBS	WAGES	AVG. WAGE
2001	13,463	$671.7M	$49,889
2002	13,376	$680.7M	$50,883
2003	13,104	$696.6M	$53,159
2004	13,106	$728.7M	$55,606
2005*	13,813	$793.7M	$57,458

TAX CREDITS CLAIMED

Technology tax credit claims jumped in fiscal 2005, according to state estimates.

Exhibit B

*Estimate
Source: State Department of Taxation, state Department of Business, Economic Development and Tourism

The Honolulu Advertiser

'It's every mother's nightmare'

More aid given for quake damage

g with
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Credits

CONTINUED FROM A1

designed to diversify Hawai'i's economy and create high-paying jobs that would keep the state's most talented youths from moving to the Mainland.

Roughly halfway through the program, the cost to taxpayers is becoming significant but the benefits are less obvious.

Hawai'i added a net 350 new tech jobs from 2001 to 2005, according to a state report released yesterday. During the same time, 40,968 total private sector jobs were created. Technology jobs account for about 2.8 percent of total private employment, or 13,813 positions.

"Of course it ($1 billion over 10 years) bothers me because it's a huge amount of money and because I can't justify it," said Senate Majority Leader Colleen Hanabusa, D-21st (Nānākuli, Mākaha). "We don't even invest that to repair our schools."

Measuring the impact of the credits is difficult because the state doesn't release the identities of the companies or track the number of jobs they create. It's impossible to know how many new tech-sector jobs would have been generated without the credits.

"There's no way to tie (the credits) to any of the activity that's happening," said chief economist Paul Brewbaker at the Bank of Hawaii. "I don't know why it was designed this way with no accountability. We don't know who is getting the credits, what they're doing, or how much money they're getting."

Since 2001, investors have been able to reduce their state income tax by $1 for every $1 invested in technology companies. An estimated $311 million in credits was given out in four years since the program's start. No other state offers a 100 percent technology investment tax credit.

The tax department estimates that during the next six years, investors will earn roughly $700 million in additional credits.

Individual taxpayers can claim up to $2 million in credits. There is no cap on the total credits the state can give, so it is impossible to know how much the credits will end up costing.

In the year ended June 30, 2005, the program cost an estimated $126.7 million in foregone tax revenue, according to the state tax department.

COMPANIES THRIVE

Supporters of the incentives point out that in recent years, local companies such as Hawaii Biotech, Hoku Scientific and Hoana Medical have grown with help from the credits. They maintain that the cost of the credits is more than offset by the economic activity they generate.

"This tax credit was an attempt to change investor behavior and shake money loose for Hawai'i technology companies," said Ann Chung, vice president of government and community affairs for the Hawaii Science & Technology Council, a trade group representing the technology industry. "If it is a billion dollars, it's an enormous positive reflection on this industry."

Chung's group and other tech industry officials said they will provide more information on the positive impact of the tax credits at a public meeting tomorrow at 9 a.m. at the state Capitol, Room 211.

The first comprehensive attempt to study the benefits of technology tax credits recently concluded the program has been successful in generating $185 million in investment capital for qualified technology businesses. However, the study also noted that information on the benefits of the program, such as the number and type of jobs created, is sketchy.

The study, by University of Hawai'i-Hilo business dean Marcia Sakai and University of West Georgia professor Bruce Bird, recommended the state create more accountability for the credits, conduct a cost benefit analysis and annually review existing tax credit programs.

Sakai and Bird estimated the technology tax credits will cost the state $600 million over 10 years.

"That's just to give some ballpark figure to show the possible magnitude," Sakai said. "Whether it's really $600 million or not is really a function of how investors behave. It could be higher or lower."

Based on the volume of credits created during the program's first four years the cost of the credits could rise to a total of $600 million, Sakai said.

"There's a need for more transparency as to the effects of tax credits," she said. "Frankly what we need to have is better measurement of the outcome of this program beyond the level of investment."

The report's authors and tech industry advocates agree that it takes time for startup companies to add jobs and that tracking technology job growth is difficult.

Chung said the Act 215/221 credits are helping to diversify the economy, generate attention for Hawai'i and entice residents to invest in local technology companies.

"I know some of that is anecdotal and difficult to quantify, but you do have to look at all those intended goals," Chung said. "You just can't look at the data in a vacuum and say, 'How many jobs have you created?' "

Chung said the state has the information needed to prove the credits are working — the state just needs to compile it and present it.

"The data out there really needs to be put together," Chung said.

Senate Majority Leader Hanabusa added, "There is no transparency in it so you cannot get that information on local job creation. Because of that I think that it's difficult to assess the benefits of it."

MORE TIME WILL TELL

House Speaker Calvin Say said it is too early to assess the benefits of the credits.

"Give it another six years and reflect on that growth in high-tech businesses and if it hasn't been successful, then the Legislature can consider amending it," he said. "At that point whether it's $1 billion or $2 billion, you can stop and say, 'Where are these high-tech jobs?' "

The credits have helped generate about $185 million in investment into Hawai'i companies since 2001, according to the state tax department.

Say said he's confident the program is helping Hawai'i's high-tech sector grow. The investment capital is spent on research and salaries, Say said.

Others aren't so sure.

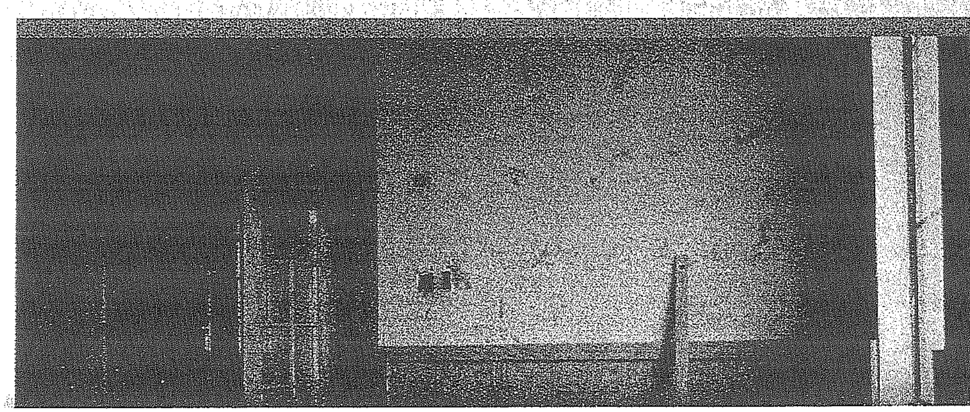
Lowell Kalapa, president of the nonprofit Tax Foundation of Hawai'i, said, "I don't see an explosion of the high-technology industry in the state."

The state should require that companies benefitting from the tax credits disclose the number of jobs created, the salaries paid and the names of companies involved in the program, Kalapa said.

"They're feeding at the public trough. We need to make sure the pigs are getting fatter," Kalapa said. "If they're not getting fatter then why are we feeding them?"

The technology industry has opposed prior legislative efforts to amend the law to require public disclosure of companies benefitting from the credits, saying such disclosures could inhibit investment.

Reach Sean Hao at shao@honoluluadvertiser.com or 525-8093.



Veggies

"People who consume the healthy fats — vegetable oils and vegetable fats — also have lower

Exhibit C

Table 1 Qualified High Technology Business (QHTB) Investments and Tax Credits

	QHTB Investments ($million)	Credits Claimed ($million)	Credits Carried Forward ($million)	Future Claimable Credits ($million)
2000	3.94	0.39	0.0	
2001	30.79	9.58	2.2	
2002	81.87	26.19	13.1	
2003 *	68.49	38.87	25.3	
2004	not yet available	not yet available	not yet available	
2005	not yet available	not yet available	not yet available	
Total	185.08**	75.03**		110.05**

* Preliminary data
** Total only through Tax Year 2003
Source: Department of Taxation

Exhibit D

Hawaii's Technology Sector: 2001-2005

Department of Business Economic Development and Tourism

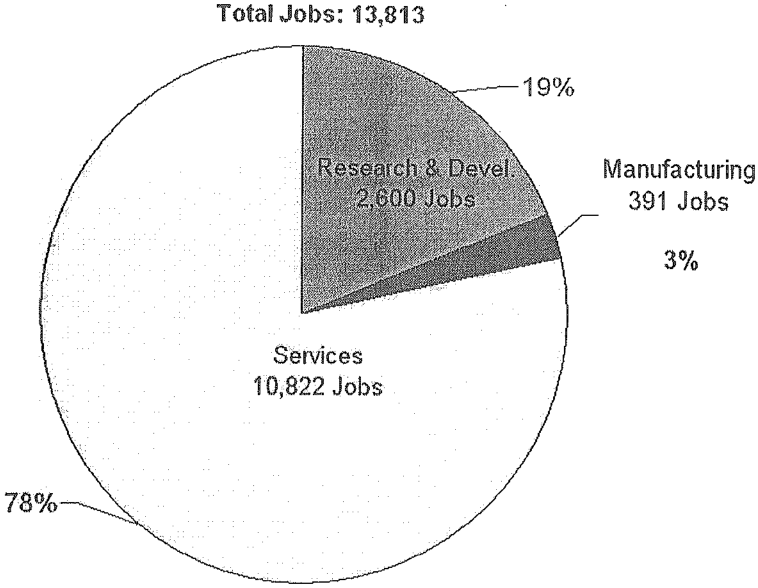
October 2006

Strong Growth in 2005 Breaks Three-Year Slide in Tech Jobs

Highlights

- Private tech sector wage and salary jobs totaled 13,813 in 2005, up 5.4% from 2004 – a gain of 707 jobs (excludes self-employed).
- 2005 growth erased a loss of 357 jobs in the sector from 2001 to 2004, caused by cutbacks in technology services and manufacturing at the time.
- R&D activity has been the strongest component of Hawaii's private tech sector, with a 36% increase in jobs from 2001 to 2005 – nearly 4 times faster than all private sector job growth.
- The average wage in the technology sector was $57,458 in 2005, 66% above the overall private sector average.
- Technology in 2005 represented 2.8% of all private sector jobs in Hawaii and 4.7% of total private sector wages and salaries, virtually unchanged from the previous years.

Technology Jobs by Type, 2005



Newly developed data show that after several years of modest decline, wage and salary jobs in Hawaii's private technology sector increased 5.4% in 2005, to an estimated 13,813 jobs. This represents a one-year gain of over 700 jobs for the tech sector. The growth also exceeded the 3.9% gain for the private sector as a whole. There were 1,115 establishments in Hawaii's technology sector during 2005. The average wage for the sector was $57,458 in 2005, 66% above the average for the private sector as a whole. The measure does not include the numbers or the income of self-employed workers in technology, which could not be measured.

It is estimated that all major components of the tech sector out performed the overall economy in 2005, including tech services, up 4.1%, Research & Development activity, up 9.3% and tech manufacturing, at an estimated 17.1% gain for the year.

During the three years before 2005, weaknesses in communications services, internet businesses and tech manufacturing dragged the sector down somewhat, despite solid gains in research and development, and other areas of growth in the technology sector. Jobs in the tech sector slipped from 13,463 in 2001 to 13,106 in 2004 before the boost in 2005.

Research & Development Activity

Research and Development (R&D) activity has been the star growth area of high tech in Hawaii over the last four years, with a robust 36.1% increase from 2001 to 2005. R&D represented about 19% of total tech sector employment in 2005, or 2,600 jobs. About a third of private R&D jobs in Hawaii were accounted for by seed corn research in 2005.

There were 149 reporting units in private R&D activity during 2005. These were mostly small firms with an average of about 17 paid employees per establishment. The average wage in R&D was $56,942 in 2005, 65% above the average wage for the private sector as a whole, which was $34,566 for the year. The average wage for R&D was up 4.3% over 2004. This compared with an overall 2.9% average gain for all private sector employees in 2005.

Technology Services

Technology services include such activities as communications, software development, internet providers and testing laboratories. Tech services represent the largest component of Hawaii's private technology sector with 10,822 jobs in 2005, or 78% of all jobs in the tech sector.

Before the healthy growth in 2005, tech services had been experiencing overall declines in job levels, dropping 5% between 2001 and 2004. The weakness was primarily centered in the communications industry which lost nearly 1,200 jobs over that three year period. Communications gained back more than 50 of those jobs in 2005. Internet activity also lost jobs in the 2001-2004 period, and the decline continued into 2005. On the other hand, Computer systems design and testing/diagnostic laboratories showed consistent, strong gains over the entire 2001-2005 period.

There were 893 establishments in Technology Services during 2005. Despite a number of large firms in this area, the was an average of only 12 paid employees per establishment. The average wage in 2005 was $58,120 for tech services.

Technology Manufacturing

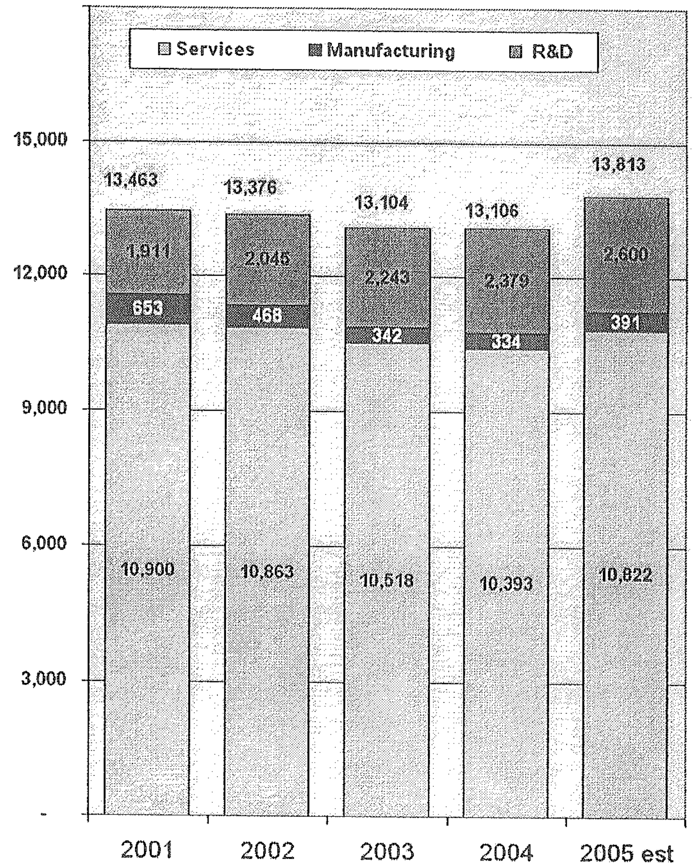
The manufacture of technology products in Hawaii is a relatively small activity, with only 391 paid employees and 72 establishments in 2005. While tech manufacturing recorded a gain jobs for 2005, the job count declined by nearly 40% from 2001 to 2004. Most of that loss is likely due to the relocation of one large firm's manufacturing operations to the Mainland in 2002.

Despite the loss in tech manufacturing jobs, the number of *establishments* in this area has increased sharply, from 56 in 2001 to 72 in 2005. This suggests that potential new manufacturing activity is percolating under the surface. The average wage in tech manufacturing was $42,552 in 2005. The average number of wage and salary jobs per establishment was just 5 employees in 2005, the lowest among the three major components of the tech sector.

More Tech Sector Data Available On Line

More data and information on Hawaii's technology sector is available on the DBEDT website at http://www.hawaii.gov/dbedt/.

Hawaii Technology Sector Jobs, 2001-2005



ABOUT THE NEW DBEDT MEASURE OF TECHNOLOGY

This new measure of technology uses data produced under the Federal/State Unemployment Insurance (UI) program. Federal and state government data programs such as UI, now use a new standard for organizing industry and employment data called the North American Industry Classification System, or NAICS. The UI program counts only wage and salary employees, not the self-employed.

Technology Sector Components
I. Scientific & Technological Research & Devel.
II. Manufacture of Technology Products
a. Medical & Pharmaceutical Mfg.
b. Miscellaneous Technology Mfg.
III. Technology Services
a. Communications Services
b. Computer Software Programming
c. Internet Infrastructure & Services
d. Testing and Diagnostic Labs & Facilities

A shortcoming in previous measures of Hawaii's tech sector was the difficulty of separating the *development* of technology from the *use* of high technology under the older, Standard Industrial Classification (SIC) system. Both the development and use of high technology are useful to measure, but they are very different activities. The new NAICS system allows us to identify major components of technology that represent a spectrum of the technology development process. At one end we can identify the core source of new technology, Scientific and Technological Research and Development. Next, we can isolate and measure the manufacture of technology products. Finally, we can identify separately the wide range of services that provide technology-based solutions that address business and consumer needs.

DBEDT incorporated valuable insight and input into construction of the new measure from partners such as the Hawaii Science and Technology Council, the High Tech Development Corporation, and Enterprise Honolulu. The core of the new measure is a group of 47, 6-digit NAICS industries identified by the American Electronics Association (AeA). An additional 19 detailed industries were added based on the recommendations of the partners noted above and DBEDT research. Data from 2001 to 2004 are based on 6-digit NAICS data for jobs, wages and employing units, from the Department of Labor and Industrial Relations. Estimated data for 2005 were based on U.S. Bureau of Labor Statistics files.

Future reports using the new data will focus on identifying technology specialties such as biotechnology, infotech, telecommunications and county-level technology activity.

Exhibit E

Honolulu Advertiser

Estimated printed pages: 3

March 13, 2003
Section: Main
Page: 1A

Tech tax break totals $46M
Hao Sean
Staff
Advertiser Final

Claims nearly triple state's expectations

By Sean Hao, ADVERTISER STAFF WRITER

Hawai`i businesses and investors claimed an estimated $46 million in tax breaks under the state's technology investment tax credit in its first year, nearly three times as much as had been estimated, according to preliminary figures released yesterday.

The tax credit is spread over five years, meaning that there was an actual reduction of $9.6 million in tax revenue in 2001, the first year of the program.

The program, known as Act 221, provides a 100 percent credit for money put into a qualifying technology venture, which has been broadly defined as anything from software development to film and video production. The state had previously estimated that about $16 million in tax credits would be claimed in the first year.

Separately, the Department of Taxation said companies saved another $9.8 million on their taxes under Act 221's research credit in 2001, the most recent year for which figures were available.

Act 221 has strong support from the business community, the Lingle administration and those who believe the tax credits help promote a diversified economy by encouraging high-technology ventures to establish themselves in Hawai`i and create new jobs. Critics say the definition of qualifying businesses is too broad and that the potential loss in tax revenue could be huge.

"That's just the tip of the iceberg," said Lowell Kalapa, president of the Tax Foundation of Hawai`i. "It's going to get bigger and bigger as more people figure out how to use it."

If investments under Act 221 continue at the same pace as in 2001, the state could see tax revenue reduced by $230 million over five years, Kalapa said. Figures on the use of Act 221 credits for the 2002 tax year won't be available until about this time next year.

In 2001, 46 businesses received Act 221 credits, according to the Department of Taxation. Among those was medical imaging device maker Hoana Technologies.

Ian Kitajima, marketing manager for Hoana's founding company, Oceanit, said the tax credits were crucial to Hoana's ability to raise $1.7 million from investors in 2001 and $2.5 million last year.

"It's been very, very important," he said. "Without it, I don't know how we would have gotten to this point in terms of momentum created here in Hawai`i."

The financial impact of tax credits are be being scrutinized by legislators and administration officials who are trying to decide whether to revise Act 221 and create additional business tax incentives, or to narrow the kinds of investments that qualify. State officials have said they are concerned that tax revenue is falling even as spending by tourists and local consumers remains fairly robust.

Overall tax collections fell slightly to $3.05 billion in the state fiscal year ended June 30, 2002, versus from $3.15 billion in 2001.

Kurt Kawafuchi, state deputy tax director, said fostering the state's fledgling technology industry is a good idea, but cautioned that based on Act 221's first year, "it could end up costing quite a bit."

"But it's too early to jump to conclusions," he said.

In a bid to improve accountability and to track the number of jobs and amount of wages created by the tax credit, the tax department plans to ask recipients of the investment tax credit to fill out special forms with their 2002 tax returns. Those forms, which are still being drafted, will be sent to those who have already filed their state tax returns, Kawafuchi said.

According to the report, the amount of tax credits claimed increased 20 percent in 2001, totaling $111.8 million. Among the major credits included:

· $7.4 million claimed under the hotel construction and renovation tax credit.

· $11.3 million claimed under the residential construction and renovation tax credit.

· $23 million claimed by businesses under the capital goods general excise tax credit.

Reach Sean Hao at shao@ho noluluadvertiser.com or 525-8093.

Drop-in:

› Filmmakers, legislators met yesterday for "Film Day." SEE STORY, PAGE B1

Exhibit F

The Honolulu Advertiser

Hawai'i's Newspaper • HonoluluAdvertiser.com

Newspaper archive powered by NewsBank

April 18, 2003
Section: Business
Page: 1D

Study finds tech growth slowed

Hao Sean
Staff
Advertiser Final

Act 221's first year in 2001 shows decline

By Sean Hao, ADVERTISER STAFF WRITER

Hawai`i's fledgling high-tech sector grew at a slower rate in 2001 - the first year of the state-granted **Act 221** tax credits to encourage investment and research in technology, according to information released by the office of Gov. Linda Lingle yesterday.

The data, compiled by the Department of Taxation and the Department of Labor and Industrial Relations, is the first measure of the effectiveness of the tax credits that have been criticized for draining tax revenues.

The growth in the technology industry started to slow in 2001 at the same time the state vastly increased the size of high-tech tax credits from 10 percent to 100 percent of an investment in a technology company, the state said. In the same year, the technology bubble burst, causing stock prices to plunge and the loss of tens of thousands of jobs nationwide.

During the **act**'s first year, the technology investment credit cost the state $9.6 million and created total potential tax losses of $46 million, which is equal to the amount investors pumped into the industry.

That $46 million in tax credits is nearly three times more than the state projected. The tax department also now estimates that a separate 20 percent technology research and development tax credit cost the state $14 million in revenues that same year.

Despite the infusion of investment dollars, Hawai`i high-tech wages and jobs at 23 select companies fell in 2001, according to the state's study.

"What it tells me is we increased the size of the tax credits by 10 times for a decline in the percentage growth of the industry," said Kurt Kawafuchi, tax department director. "We expected it to be more because there's a lot of money coming into the sector."

The new figures were released as Lingle renewed her push to change **Act 221** by limiting the tax credits to those who increase their spending on research and development and removing language requiring the tax department to interpret the **act** liberally.

Concern about **Act 221** and other state income tax credits has grown in recent weeks after the Council on Revenues blamed the incentives rather than the economy for lower-than-expected tax collections in the current fiscal year.

The reduced forecast forced lawmakers to revise their budget plans and consider raising money through estate taxes, a general excise tax increase and use of certain special funds.

Lingle opposed changing **Act 221** during her gubernatorial campaign, then changed positions because of the state's tough financial position, which includes a $118 million budget shortfall for 2004 and 2005.

Changing the law would free up $55 million in those two fiscal years, she told the Hawai`i Economic Association yesterday. She also cited several examples of what she said was misuse spurred on by a cottage industry of accountants, consultants and law-yers.

While the Senate has passed Lingle's changes, key House members remain opposed to changing the law.

Lawmakers "don't need to be worrying about saving face on this issue," Lingle said. "They need to worry about saving **Act 221**."

Proponents argue that the tax credits are crucial to fostering the growth of the state's high-tech industry. Critics complain the **act** is too generous and has been used to finance one-shot, nontechnology ventures including motion pictures such as the surfing film "Blue Crush."

Until yesterday, the state could not say how many jobs have been created under the law. The Hawai`i Technology Trade Association, in support of retaining **Act 221**, recently released a survey of 15 high-tech companies benefiting from tax credits that said they expected to create 1,000-plus jobs by 2006.

In analyzing the impact of **Act 221**, the tax department looked at changes in high-tech jobs state-wide and at 23 specific high-tech companies. Between 1999 and 2000 the number of technology jobs overall grew 4.8 percent to 13,016, then slowed to 4.1 percent in 2001 when 537 jobs were created.

At the 23 companies benefiting from credits the growth rate slowed from 75.8 percent and 116 new jobs in 2000 to 11.2 percent growth in 2001 when only 30 jobs were created. In 2002, these companies reduced their workforce by 10.7 percent or 32 jobs.

Wage growth for technology jobs statewide also fell from 11.1 percent in 2000 when salaries totaled $646.2 million to 6.5 percent in 2001. Wage growth also slowed at the 23 companies studied between 2001 and 2002.

Philip Bossert, chief executive for the High Tech Development Corp., said he was not surprised by the lack of job and wage growth given the technology industry meltdown that started in 2001.

Bossert said he supports amending **Act 221** but only after 2005 when the law is due to expire. Changing the law now would send mixed signals to investors, he said.

"I would argue to be patient," he said. "I think the impact of what is going to happen as a result of the tax credits has yet to be seen."

Brian Schatz, D-25th (Makiki, Tantalus), also attributed the absence of significant job and wage growth to a slowdown in the industry. He remains opposed to changing **Act 221** this session, but offered no specific revenue-generating alternatives.

"The central issue is to stay the course in diversifying the economy," Schatz said.

Reach Sean Hao at shao@hono luluadvertiser.com or 525-8093.

Subj: **Re: We welcome your comments**
Date: 10/12/2006
To: bbird@westga.edu, achung@hawaiiscitechcouncil.org, jau@pacificap.net, bspencer@hawaii.rr.com
CC: bbird@westga.edu, marcias@hawaii.edu

10/11/06

Bruce,

Thanks for welcoming our further comments. It is an extremely busy time for us, with Oct. 15 federal and Oct. 20 state tax filing deadlines approaching, in addition to several investments we are working on getting closed, so I really don't have time right now to compile data from our portfolio companies. Some of them are also very concerned about preserving confidentiality. Frankly, some are also a bit fed up with the atomosphere of negative politics and press spin that has surrounded Act 221 for the past several years and would therefore prefer to just focus on their research and executing on their sales, marketing and business plans.

I haven't had time to carefully review your draft report, but the following are some preliminary comments after a quick read:

1. p. 2: You might want to interview Act 221 investors to measure the extent that negative politics and press spin surrounding Act 221 has affected the "Business Climate" in Hawaii and our state's grade of "F" for "business vitality" and "development capacity." This also can be well documented by comparing the numerous press articles with negative "press spin" on Act 221 over the past 5 years with empirical data subsequently released by the Department of Taxation to date. If there is a large discrepancy between them, then the question is what and who are the sources of these discrepancies and why. Out of curiosity, are the press articles and secondary sources you quote ones that you independently found from your own research, or were they provided to you by someone?

2. p. 4 paragraph 2: Is this comment from the 2001-2003 Tax Review Commission Report an empirical finding or editorial comment? How do comments like these affect the press, investment environment and the Tax Review Commission's mandate for objectivity?

3. p. 10: This is not the correct legal definition of "Investment" under Act 221. The correct definition is in Section 235-1, HRS, not TIR 2003-1.

4. p. 13: Regarding the quote from DBEDT Director Ted Liu that "Liberal construction has not achieved its purpose, rather it's done the opposite by overloading the Department of Taxation in reviewing proposals they shouldn't be." Have you asked Mr. Liu what empircal data supports this assertion and how he obtained it, given that requests to the Tax Department are confidential and should not be accessable to DBEDT? Have you asked Tax Director Kawafuchi if he agrees with this conclusion, and if so, what empirical evidence there is to back it up, e.g., how many proposals had to be reviewed that shouldn't have been, but for "liberal construction?"

5. p.14: Regarding the question of whether Act 221 has increased investment in Hawaii technology companies, why do you cite national studies that often miss and exclude many Hawaii investors, rather than citing the primary source Department of Taxation data on your Table 1 that shows more than $185 million invested between 2000 and 2003? As I previously mentioned, our firm alone invested much more than $2.9 million in 2002. Is Hawaii's small share of venture capital relative to other states due to Act 221 or other factors, such as larger populations, mature venture capital sectors, economies, tax bases, etc. of other states? Have you compared the growth rate of technology investment in Hawaii compared to the growth rate of technology investments in other states during the period under study? Would this be a more appropriate measure of Act 221 than Hawaii's ranking? Could you clarify the logic of Mr. Weinman's quote that "Act 221. . .discourages the formation of a large pool of capital here. . . " Pension funds, endowments and trusts are primarily nonprofits that pay no tax and for whom tax credits have no impact. How do you distinguish the "better companies" from the "tax deals" in Hawaii when most Act 221 investments included BOTH investors receiving tax credits AND investors receiving ZERO CREDITS, investing in the SAME COMPANY at the SAME TIME? How can the SAME COMPANY be BOTH a "better company" and (an implicitly "bad") "tax deal" at the SAME TIME? Hypothetically, how does the existence of "tax deals" discourage investment in "non-tax deals" by nonprofit pension funds, endowments and trusts, for whom tax credits are irrelevant and have no impact, either positive or negative? Logically, how would tax credit investors investing in lousy deals in any way affect or prevent tax exempt investors from investing in completely unrealated "better company" nontax deals? Is there any empirical evidence to show that these nonprofit institutional investors are in fact so philosphically opposed to the preferential tax treatment of Act 221, and if they are, why don't they give up their own tax exempt status? What has a greater negative impact on Hawaii tax revenues--Act 221, or the tax

exempt status of pension funds, endowments and trusts? Should the same cost-benefit analysis and metrics be applied to both?

6. p. 17: To have a complete analysis, you must also measure the UNUSABLE credits, i.e., the credits that will NEVER be claimed, but for which cash investments were made, the proceeds of which still create jobs, generate payroll and general excise tax, etc. For some TV and film QHTB's, unusable credits that may never be claimed could be 80% or more of all potential credits. This may be due in part to some QHTB's having to wait up to 11 months to get their comfort letter rulings, thus having only a few days to raise money before the end of the tax year, as well as the structural limitation of how little Hawaii state tax liability most investors have with the highest marginal rate for individuals being only 8.25%.

7. p. 19: You state that data from Forms N-317, N-318 and N-318A can be aggregated to assess Act 221's effectiveness. These aggregated data provided by the Department of Taxation appear in the various tables included later in your study (albeit only through 2003). Yet, you ask, "Why has the Department of Taxation not conducted an evaluation that no other entity can conduct because of the confidentiality issue?" Is your criticism that the Department of Taxation A) has not properly aggregated the relevant data in the tables included in your study; B) that you do not trust how the Department has aggregated these data, and that you would like to review and audit individual tax filings yourself to aggregate the data yourself; and/or C) that as a matter of policy, analysis and audits of private tax returns should be conducted by the public rather than the Department of Taxation? Are the policies of confidentiality you criticize unique to Act 221, or do they apply to all other tax credits and tax reporting? Why does the privacy and confidentiality of individual taxpayers need to be compromised for you to get the aggregate data you need when this aggregate data is cited in tables provided by the Department of Taxation later in your study?

8. pp. 19-21: Could you comment on the appropriateness of evaluating the Act 221 Investment Tax Credit by using gross revenues (and GE Tax) and employee data at this point in time. Would these metrics that you have selected significantly underestimate the benefits of Act 221 when A) research companies that have no product to sell in early years often have ZERO revenues; B) tech companies that create higher paying jobs create FEWER jobs for the same amount of money (e.g., $100,000 could get you 5 hotel maids or just one senior software engineer); C) many small companies use "employee leasing companies" to minimize administrative paperwork; D) both tech companies and most TV and film production companies often use indpendent contractors rather than employees. A production company that spends tens of millions of dollars in Hawaii on very large production crews may have very few employees. Why have you not included in your analysis the independent contractors and vendors of QHTB's, as well as the Excise Taxes, Payroll Taxes generated by independent contractors and vendors? E) Many founders and employees of early stage tech companies often take below market or even no cash salary, typically in exchange for sweat equity. I would guess that Hewlett and Packard did not draw very large salaries from that company started in that famous garage in Palo Alto many years ago. If companies like this that create no jobs up front are funded as a result of Act 221, is this a bad thing from a policy standpoint?

9. pp. 31-34: The Form N-317 primary source data you cite from the Department of Taxation shows 1,980 and 2,209 jobs created by 78 and 131 QHTB's in 2002 and 2003, respectively. Why do you also cite additional data from DBEDT showing declines in jobs in technology sectors unrelated to Act 221? Why is this extraneous data even relevant to an analysis of Act 221, and why has it been inserted into the analysis? Who gave you this data? Did he or she explain to you the full implications of it and its relevance to Act 221?

10. p. 32: Your hypothetical example of an entrepreneur investing in his own single member LLC QHTB to shelter $280,000 of Hawaii state income tax in 2006 would require that entrepreneur to have close to $3.4 million in Hawaii taxable income in that year. Is this a realisitic scenario? Is there any empircal evidence to suggest that this scenario exists, or is this pure conjecture?

11. p. 35: Does the audit data you cite refer to the Investment Tax Credit or the R&D Credit, which is not the subject of your study? What and who are the primary sources of the press articles you cite, and how do these articles now compare with empirical data from the Department of Taxation? How accurate or inaccurate have press reports on Act 221 been from a factual standpoint. You could easily set up a table citing various press quotes in one column, the date and source in the second column, and the actual empirical data from the Department of Taxation in the third column. If Tax Director Kawafuchi expressly stated at the Tax Review Commission's meeting that these audit numbers are wrong, how is it that both the press and your report conclude that e.g., "15 to 20 percent of the dollar total of Act 221 claims might violate criminal or civil laws." If these are false or misleading conclusions, the solution is not to simply exclude them from your report. It is incumbent upon you to interview the primary sources of these quotes, the relevant press reporters and government officials to get to the bottom of the question of if, how and why the press has been mislead on Act 221 and whether this has been inadvertent or deliberate. This is very relevant to your study and goes directly to the issue of Hawaii's grade of "F" for business climate cited on page 2 of your report.

12. Other Issue: The RFP for your study expressly required the analysis of several different tax credits. Such an analysis would provide a comparative perspective in evaluating the Act 221 Investment Tax Credit. Yet, your study only analyzes one credit. Why is this? Did you independently decide to study just this one credit, or were you instructed to do so, and if so, by whom and why? Is this in violation of the RFP, and more broadly, state procurement laws?

Please understand that my questions and comments above are preliminary in nature and are from just an initial quick review of your draft study, as I have not had time to do a more detailed analysis. Please feel free to contact me if you have any questions or comments.

Aloha,

Jeff

Jeffrey Au
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In a message dated 10/10/2006 8:19:50 PM Hawaiian Standard Time, bbird@westga.edu writes:

> Dear Ann, Jeff, and Bill:
>
> Thank you for attending our presentation last Friday.
>
> We are in the process of preparing our Final Report to the Tax Review Commission.
>
> We welcome any written comments or suggestions you might have regarding Act 221/Act 215. In addition, we welcome any compiled data that you would care to make available to us. Please feel free to e-mail me at bbird@westga.edu.
>
> Very Truly Yours,
>
> Bruce M. Bird

Attachment 15

"Henry Ting" <hting@nbt168.com>
10/13/2006 06:24 AM

To <donald.j.rousslang@hawaii.gov>
cc
bcc
Subject Hawaii High Tech Tax Incentives (Act 221/215)

History: This message has been replied to and forwarded.

Dear Sir:

I have a successful software company in Silicon Valley, California. In 2002 I was attracted by the potentials presented in Hawaii's Act 221 incentives, and established a software company on Maui. Subsequently however I realized that Maui does not have nearly the adequate infrastructure and talent pool to staff this new venture. To make matters worse, Maui does not have the high tech education environment (e.g. the lack of a fully accredited UH-Maui campus) to produce qualified software engineers that we need, and in an island geography, it is impractical to recruit from Oahu. Therefore, my Hawaiian venture failed to launch, and did not benefit from Act 221.

It is my observation that the companies that have benefitted from Act 221 are some of the largest companies, defense contractors, and film production companies that have many other established offices elsewhere in the country. Again, my not so in-depth observation did not suggest to me that these incentives have significantly help the State of Hawaii (and Maui specifically) making any inroad in the incubation of a viable high tech economy. Rather, in my humble opinion, these high tech incentives have been compared to tax breaks to the rich.

Perhaps tax incentives and public sector funds are better invested in high tech education that will in time create a indigenous talent pool. It is not easy to re-create a high tech environment such as Silicon Valley in California (where no incentives were needed or offered, and yet everybody wanted to be there) or Research Triangle Park in North Carolina, and elsewhere. A robust higher education environment seems to be a common anchor that is a necessary ingredient.

Sincerely,

Henry Ting, President
NBT 168 Technik, LLC

Attachment 16

"Steve Perkins" <steve@medb.org>
10/19/2006 02:47 PM

To <donald.j.rousslang@hawaii.gov>
cc
bcc
Subject Act 221/215 Written Testimony Attached

History: This message has been forwarded.

Dear Mr. Rousslang,

Please see the attached written testimony for the consideration of the Tax Review Commission.

Thank you for your assistance. Please contact me if you have any questions.

Sincerely,

Steve Perkins
Program Director
Maui Economic Development Board, Inc.
1305 North Holopono Street, Suite 1
Kihei, Maui, Hawaii 96753
PH: 808-875-2432
FAX: 808-879-0011
www.hightechmaui.com
www.medb.org

Act_221_215_Tax_Review_Commission_testimony102006.PDF medb

maui economic development board, inc.

October 20, 2006

Mr. Isaac Choy
Chair, State of Hawaii Tax Review Commission
P.O. Box 259
Honolulu, Hawaii 96809

Re: Act 221/215 High Technology Tax Incentives

Dear Chair Choy,

Thank you for this opportunity to provide testimony regarding the Act 221/215 high technology tax incentives.

The Maui Economic Development Board, Inc. was founded 24 years ago with economic diversification as one of its primary goals. Hawaii's high technology tax incentives have played a significant role in growing Maui's tech industry, and figure prominently in MEDB's current and future business development efforts. MEDB is aware of well over a dozen high technology companies on Maui Island that have used the credits to grow their businesses.

Maui County's technology industry now has over $145 million in yearly revenues, $40 million in payroll, and employs over 1,200 Maui residents. These jobs pay an average of $ 70,000 per year. By way of comparison, Maui's tech industry has more revenue, jobs, and a pays a higher average annual salary than each of two highly visible Maui entities-Maui Land & Pineapple and Hawaii Commercial & Sugar Company.

Since its inception, Hawaii's technology tax credits have endured numerous bouts of controversy and calls for changing the law. The uncertain long term status of the incentives has served to chill investor interest, and needlessly slow industry growth. For a true benchmarking of the potential future effectiveness of the incentives, several key components need to be in place:

1. The tax incentive legislation should be allowed to run its course without change or threat of change.
2. As a State, we need to "walk the talk" on the expressed collective public interest in growing diversified industry, and make public investment a priority.
3. We need to clearly and more aggressively publicize the incentives in Hawaii, on the US mainland, and internationally. A clear public commitment to growing diversified industry, coupled with the existing incentives, will demonstrate that Hawaii sincerely wants to succeed in this area.

Even with the continual call to repeal the incentives, there is no denying that diversified industry has grown in Maui County and Hawaii since their inception. The Maui Economic Development Board supports leaving the incentives unchanged, and allowing them to run their course.

Sincerely yours,

Jeanne Unemori Skog
President & CEO

1305 N. Holopono Street, Suite 1, Kihei, Hawaii 96753 · (808) 875-2300 · FAX (808) 879-0011 · info@medb.org · www.medb.org

Attachment 17

"David B. Fisher" <dfisher@maui.com>

10/20/2006 03:07 PM

Please respond to dfisher@maui.com

To donald.j.rousslang@hawaii.gov

cc Darryl Mleynek <darryl.mleynek@hawaii-sbdc.org>, steve@medb.org

bcc

Subject Testimony on Act 221/215 for Tax Review Commission

History: This message has been replied to and forwarded.

Please accept the attached comments on Act 221/215 and note that they are not the official view of the Hawaii SBDC Network or its sponsors. They are in response to a request to provide testimony by Steve Perkins of the Maui Economic Development Board, Inc.

Aloha

David B. Fisher, MBA
Maui, Hawaii

David B. Fisher
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808-875-2402 voice
808-875-2406 fax
http://CoolProjectsMaui.com - DF blog and podcast
http://MauiEnterpriseForum.Net - Maui and DF info
http://www.hawaii-sbdc.org - statewide program website

I am using SpamArrest spam filter. Fisher_on_Act_221_on_10_20_06.pdf

David B. Fisher
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Paia, HI 96779
http://MauiEnterpriseForum.net

October 20, 2006

Mr. Isaac Choy
Chair, State of Hawaii Tax Review Commission
P.O. Box 259
Honolulu, Hawaii 96809

Re: Act 221/215 High Technology Tax Incentives

I have read in the newspapers about the claims that Act 221/215 has resulted in a net loss of jobs and have been told of this opportunity to provide testimony by colleagues at the Maui Economic Development Board.

As the Center Director and primary service provider for the Hawaii SBDC Network on Maui for the last 16 years (and with nine years similar experience in New York City) I work in the trenches with entrepreneurs helping them develop their business plans and financial strategies.

In the Fall of 2002, Cielo Molina in the Maui Office of the State Tax Dept. asked me to participate in a statewide video conference with others in the Tax Department where I shared my very positive experience with Act 221 as well as articulated the unique role of the Tax Department in collecting information to evaluate the program. In general the Tax Department, although understaffed, has been very supportive and always interested in how to do better. This includes current Tax Director Kurt Kawafuchi who has made a special effort to meet with QHTB users on Maui every year since the fall of 2004.

I have helped six small start-up companies on Maui obtain QHTB comfort letters and have helped many others considering applying and taking advantage of the incentives. To date these companies have raised over $1.5 million and represent about 23 new jobs although some of these are independent contractors. Two of these companies are currently in serious negotiation for financing adding up to over $10 million in investment, hopefully before the end of the year.

With the beginning of public criticism of Act 221 in January of 2003, investment in QHTB's, as seen by my office, declined primarily because investors and their accountants were worried about being potentially involved in what was being portrayed as questionable activity.

One of my strongest QHTB companies, a non-fossil fuel energy company that was founded on Maui, decided based upon the response of their accountant as to their use of the R&D credits in 2004 to move in 2005, their research and development operations with over half a million dollars in annual budgets, to Oregon where the State Government was much more welcoming. We are currently working to get some of this company's R&D operations back and believe they may make use of the investment tax credits for to raise money for an expansion in Hawaii.

Fortunately, the State Legislature extended Act 221 with Act 215 in the summer of 2004 and almost two years later, almost four years after the initial negative press on Act 221, we may be back on track, although after the latest press generated by the Tax Review Commission, maybe not.

I strongly encourage you to consider the effects of your studies and resulting communications with the public. There are some simple steps that you can take:

1) Talk in person to the people using Act 221/215 – the companies, investors, professional service providers, and most of all the Tax Department. Do not exclusively rely on secondary, frequently inaccurate econometric models – when the real data is readily at hand. Paper and phone surveys are not likely to be accurate gathering this kind of data—the numbers of companies are small enough, make the effort to get the information.

2) Include proponents and users of Act 221/215 as well as critics of Act 221/215 in the development of the questions, the collection of the data, the analysis of the data, and the presentation of the results.

    a. One critical question to ask is "how many independent contractors have you hired?" Many of my QHTB clients hire specialist consultants, engineers, and even university professors—all of whom are necessary to move to a diversified economy.
    b. You might also look at the effect of the post 9/11 "War on Terrorism" construction boom and real estate market and its effects of investor decisions.
    c. And of course, you should also look at the effects of negative press, cuts in technical assistance and educational programs since 2003 (examples include the Hawaii SBDC Network and MEDB on Maui) on planning and investment in QHTB's.

3) Take utmost care in presenting the results, focusing on facts. Be sensitive to how the information is going to be used by investors and their advisors not used to investing in knowledge businesses. Unless you have proof and have people under indictment do not use words like "fraud", "scam", etc.

Mahalo for this opportunity to provide input.

David B. Fisher, MBA*
Maui Center Director
Hawaii SBDC Network (Maui)**

* Also the U.S. Small Business Administration's Financial Services Champion for the State of Hawaii 2006, and successful nominator of Jeff Au of PacifiCap in 2005, and Ray Kamikawa, former Tax Director, in 2002 for the same award.

**Note these are not the official views of the Hawaii SBDC Network

"Scott Weeker" <sweeker@ambient-micro.com>

10/21/2006 04:43 PM

Please respond to <sweeker@ambient-micro.com>

To <donald.j.rousslang@hawaii.gov>

cc

bcc

Subject ATTN Chairman Isaac Choy-Tax Review Commission

History: This message has been replied to and forwarded.

ambient micro

Maui Research & Technology Center | Suite 127, 590 Lipoa Parkway, Kihei, Hawaii 96753
tel 866.561.4823 | cell 808.250.7061 | fax 866.728.9726 | email info@ambient-micro.com

October 21, 2006

Mr. Isaac Choy
Chairman, State of Hawaii Tax Review Commission
P.O. Box 259
Honolulu, Hawaii 96809.

RE: Positive Impacts of High Technology Tax Credit Program

Aloha Chairman Choy,

I would like to add my support for the continuance of Hawaii's High Technology Tax credit program. I believe that it provides a very positive impact on investment and long term job growth. I also believe that this positive impact is only now beginning to reach fruition due to the uncertainty over the program's future among Hawaii and Mainland investors during the 2004/2005 controversy that led to the adoption of Act 215. That controversy had a very real "chilling effect" on both local companies and investors that is just now being overcome.

The tax credit program has been a direct benefit to our small company is that it provides a path to near term Angel Funding and longer term investment capital needed to reach economic sustainability. The State's HTDC and HTDV programs have been extremely helpful in stimulating the early development of Hawaii's small high technology businesses-but these programs can not provide the access to the capital required for the successful commercialization of new technologies. Only the access to capital represented by the tax credit program can offer the potential for the longer term funding needed to be able to recruit and retain qualified staff.

Another positive benefit is the refundable tax credit program that provides small companies like ours with the critical 'bridge" funding that can help us continue operations while seeking government development contracts and/or commercial sales.

Though a "lag time" between investment and job growth should be expected, I sincerely feel that when accurate data is available, it will show that the Hawaii high technology tax programs have had, and will continue to have, a significant positive impact in building "living wage" jobs here in Hawaii.

Thank you for your consideration.

Aloha,

Scott A. Weeker
President/CEO
Ambient Micro, LLC

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President/CEO
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