LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

KURT KAWAFUCHI
DIRECTOR OF TAXATION

STANLEY SHIRAKI
DEPUTY DIRECTOR

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

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

April 16, 2010

LETTER RULING 2010-08

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

RE: APPLICATION OF TAX INCENTIVES TO [REDACTED TEXT]

Dear [REDACTED TEXT]:

This responds to the request of [REDACTED TEXT] of [REDACTED TEXT] (the Company), requesting a ruling from the State of Hawaii Department of Taxation (the Department") that the Company is eligible for certain tax incentives under Hawaii law.

Hawaii offers the following tax incentives to qualifying businesses:

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

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

3. The income tax exclusion for income earned and proceeds derived from stock options or stock, including income from dividends from stock or stock received through the exercise of stock options or warrants, the receipt or exercise of stock options or warrants, and the sale of stock options or stock, including stock issued through the exercise of stock options or warrants, under §235-9.5, HRS;

4. The tax credit for research activities under §235-110.91, HRS; and

5. Other miscellaneous tax provisions.

SHORT ANSWER

Based on the information in your letter request for a high technology comfort ruling and the questionnaire, "Does a Company Qualify for Hawaii Tax Incentives?" the Company will qualify for the tax benefits in paragraphs 1, 2, 3 and 4 above, provided that the cash investments received by the Company do not exceed $3,700,000. The Company may also qualify for other miscellaneous income tax and general excise tax incentives.

FACTS REPRESENTED BY THE COMPANY

The Company operates as a start-up research and development company that is headquartered in Hawaii. The Company's members include: [REDACTED TEXT] ("Manager"), the Managing Member, and the special purpose entities, [REDACTED TEXT] ("SPE") and [REDACTED TEXT]. Any cash invested by Manager, whether directly or indirectly, will not generate a high technology business investment tax credit other than for itself. As further explained below (*see* Proposed Investment Structure), the Company will receive up to [REDACTED TEXT] in capital in 2010. The [REDACTED TEXT] capital contribution (together with the [REDACTED TEXT] capital contribution in 2009) will provide necessary working capital to either pursue new research projects or expand the scope of existing research activities through 2015.

The Company's primary source of revenues will be royalties generated from the sale or other commercial exploitation of the technology and intellectual property that it develops either independently or with other companies. Due to the nature of its business and revenue source, the Company does not expect to realize any significant revenues from its activities for at least 2010 and 2011 and, possibly longer. Further, rather than maintain a permanent research staff, the Company will engage independent contractors and other businesses that are wholly unrelated to the Company, that are based in Hawaii (and which themselves, may be qualified high technology businesses as defined in § 235-110.9(g) pursuing any of the available high technology tax incentives provided by HRS, with or without respect to contractual obligations performed on behalf of the Company), to perform research on a project-by-project basis. The Company contracted with [REDACTED TEXT], which conducts [REDACTED TEXT] in Hawaii for much of its research and development activity. The Company has and will include in the research contract with [REDACTED TEXT], or any other business doing research on behalf of the Company, a provision stating that the contractor agrees not to count the activities performed pursuant to the research contract as qualified research activities for its own account. In addition, the Company leases an office in Hawaii and Manager will provide all administrative, accounting and office support services to the Company under an administrative services agreement.

The Company represents that at least 50% of the Company's total expenditures for each year in the first five years of operation will be in qualified research and at least 75% of such qualified research in each of the first five years of operation will be for qualified research activities conducted in the State of Hawaii.

Proposed Investment Structure in the Company

To facilitate the funding and syndication to the Hawaii Investors of a qualified equity interest ("QEI") of up to [REDACTED TEXT] in the Company, the Manager has organized SPE as a bankruptcy remote special purpose entity solely for the purpose of making the QEI and allocating the profits, losses, investment tax credit, and other attributes realized from that QEI to certain institutional investors that are Hawaii taxpayers (the "Hawaii Investors") and the Manager. The Manager will be the sole managing member of SPE. Exhibit "A", attached hereto, sets forth a schematic depiction of the ownership and investment structure.

Prior to December 31, 2010[1]: (i) the SPE will issue to the Hawaii Investors 100% of the Non-Managing Membership of SPE in consideration of the unconditional and irrevocable commitment of the Hawaii Investors to provide to the SPE cash in an amount equal to 100% of the QEI (referred to herein as the "Investor Capital") no later than December 31, 2010 (or earlier if §235-110.9, HRS sunsets earlier) pursuant to the terms of a written subscription agreement; and (ii) [REDACTED TEXT] (the "Fund") will make a cash bridge loan to SPE in an amount equal to the Investor Capital as an advance against the unconditional and irrevocable commitment of the Hawaii Investors. The unconditional and irrevocable commitment of the Hawaii Investors will be pledged by SPE to Fund to secure the payment of the bridge loan, and therefore, under the terms of the subscription agreement, the Hawaii Investors, and not SPE, will be severally responsible for the satisfaction of the bridge loan.

The Fund is a Delaware limited partnership organized as a bankruptcy remote special purpose entity solely for the purposes of the transaction described herein. Prior to December 31, 2010, the Fund will issue and sell a series of debt securities to capitalize the Fund. The Fund's capitalization will consist of the capital contributed by its partners and these debt securities.

Prior to December 31, 2010, the SPE will contribute all of the proceeds of the bridge loan to the Company as the QEI, to generate QHTB tax credits in an aggregate amount equal to the Investor Capital. The QEI will only generate QHTB tax credits to the extent of the cash Hawaii Investors contribute to the SPE by December 31, 2010, as a result of the unconditional and irrevocable commitments and will not include any amounts used to pay interest on the bridge loan. The Investor Capital will not be refundable by the Company and any distributions with respect to or redemption of the Investor Capital will be dependent upon profits of the Company.

The operating agreement of SPE provides for two classes of equity ownership interest ("Units"): Non-Managing Membership Units and Managing Membership Units. The Non-Managing Membership Units will be issued to the Hawaii Investors pro rata in proportion to each Hawaii Investor's Investor Capital. The Managing Member will make a capital contribution equal to less than 1% of the Investor Capital. Under the operating agreement, profits, losses, and other attributes of the Company, including the QHTB tax credits, will be

[1] In the event §235-110.9, HRS sunsets earlier than December 31, 2010, such earlier date shall control the timing of the investments and the amount of investment tax credits generated as a result of such investment.

allocated among the Hawaii Investors, as holders of the Non-Managing Membership Units and the Managing Member, as holder of the Managing Membership Units, pro rata in proportion to the positive balances of their respective capital accounts until such balances are reduced to zero. The QHTB tax credits generated by the QEI will be in an amount equal to no more than one times the amount of the Investor Capital and will be allocated ratably over the 5-year tax credit schedule to the Hawaii Investors on a pro rata basis in a manner consistent with substantial economic affect and any other requirements of § 704(b), Internal Revenue Code.

Each of the Hawaii Investors will be a "C" corporation for Federal income tax purposes. All of the Hawaii Investors file Hawaii income, franchise, or gross premiums tax returns. Some of the Hawaii Investors may be members of the same consolidated group of corporations for purposes of Federal income tax reporting and filing. To the extent any Hawaii Investor files consolidated Federal tax returns, or is under common control, with another Hawaii Investor, both Hawaii Investors are separate Hawaii gross premiums taxpayers, filing separate Hawaii gross premiums tax returns and separately liable for gross premiums tax in Hawaii based on each such Hawaii Investor's respective gross premiums.

The Company has also represented that the cash investments to be received by the Company through use of the high technology business investment tax credit under §235-110.9, HRS will not exceed $3,700,000.

LAW AND ANALYSIS

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

I. High technology business investment tax credit

For investments made in taxable years beginning after December 31, 2000, but before taxable years beginning after December 31, 2010, a nonrefundable high technology business investment tax credit of up to $2,000,000 per taxpayer is available. The credit is graduated over five years (35% to 10%) from the date of the "investment" [2] in a QHTB for investments made in tax years 2001 to 2010.[3] The credit is capped at varying amounts ($700,000 in the year the

[2] "Investment" is defined as "a nonrefundable investment, at risk, as that term is used in §465, IRC, (with respect to deductions limited to amount at risk), in a qualified high technology business, of cash that is transferred to the qualified high technology business, the transfer of which is in connection with a transaction in exchange for stock, interests in partnership, joint ventures, or other entities, licenses (exclusive or nonexclusive), rights to use technology, marketing rights, warrants, options, or any items similar to those included in this definition, including but not limited to options or rights to acquire any of the items included in this definition. The nonrefundable investment is entirely at risk of loss where repayment depends upon the success of the qualified high technology business. If the money invested is to be repaid to the taxpayer, no repayment except for dividends or interest shall he made for at least one year from the date the investment is made. The annual amount of any dividend and interest payment to the taxpayer shall not exceed twelve per cent of the amount of the investment." *See* §235-1, HRS.

investment is made to $200,000 in the last year). If the tax credit exceeds the taxpayer's income tax liability for any of the five years that the credit is taken, the excess of the tax credit over liability may be used as a credit against the taxpayer's income tax liability in subsequent years until exhausted.

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

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

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

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

Some of the credit claimed will be recaptured from the investor if at the close of any taxable year in the five-year period: (1) the Company no longer qualifies as a QHTB, (2) the Company or an interest in the Company is sold by the taxpayer investing in the QHTB, or (3) the taxpayer withdraws the taxpayer's investment wholly or partially from the QHTB.

---

[3] Taxpayers may continue to claim the credit if the five-year period to claim the credit commences in taxable years beginning before January 1, 2011, or such earlier date if §235-110.9, HRS sunsets earlier.

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

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

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

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

   (a) Products sold from, manufactured, or produced in Hawaii; or
   (b) Services performed in Hawaii (sometimes referred to as the Gross Income Test").[4]

If a company contracts with another company to perform qualified research, the research will qualify as research performed by the company for purposes of the QHTB activity test only if the contract meets the following requirements:

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

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

(3) The contract provides that the research is to be performed on behalf of the company and the company will have the substantial rights to the research results;[5] and

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

The research done by the contracted party will qualify as research performed by the

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

[5] If the Company receives a license to use the results of the research (rather than ownership rights to the results of the research), the term of the license must be for the useful life of product(s) or research.

Company only to the extent the Company has actually paid for the research and the contracting party has actually performed the services in the applicable year. For example, if the Company and the other person enter into a contract that meets the requirements above and the Company agrees to pay the other person $1,000 for the research, and further, if the Company pays the other person the $1,000 before the research is conducted and only half of the research is conducted during the tax year, then the Company may only use half the cost (assuming it is earned by the other person under the contract) when determining whether it meets the Activity Test described below. If the other half of the research is conducted in the following year, then the other half of the contract amount may be used by the Company when determining whether it meets the Activity Test in the second year. As far as the other person is concerned, its costs to conduct the research for the Company would be non-qualifying costs when determining whether the other person meets the requirements of the Activity Test.

If another person contracts with the Company to have the Company perform qualified research, the research will not qualify as research performed by the Company for the purpose of determining the Company's status as a QHTB unless the Company bears the risk of loss and the Company has substantial rights to the results of the research, even if the other person is not a QHTB.

The Department has also released Tax Information Release ("TIR") 2008-04 (Certain Prototype Costs That May Be Eligible for the Hawaii Tax Credit For Research Activities Under Section 235-110.91, Hawaii Revised Statutes) and Announcement 2008-07 (High Tech Comfort Rulings Relying Upon the Gross Income Test) which are incorporated by reference herein.

Indirect Investments

In general, an investment may be made directly in the Company or indirectly through a partnership or limited liability company taxed as a partnership for income tax purposes (a "pass-through entity"). If the investment is made indirectly through a pass-through entity, the amount of the credit will be treated as though generated at the pass-through entity level without regard to the $2,000,000 credit limitation, with the entire credit amount then allocated to the partners or members. Because the credit limitation applies at the level of the taxpayer-investor, the amount of allocated credit that may ultimately be claimed by an investor is subject to the limitation of $2,000,000 per annual investment in each QHTB.

Thus, for example, if SPE syndicates the investments to Hawaii Investors who become owners of Units of SPE and SPE invests a total of $4,000,000 (consisting of Investor Capital and Manager Capital) in the Company in 2010, each Hawaii Investor who is subject to Hawaii income, franchise, or gross premiums tax may be permitted to claim a maximum tax credit of $2,000,000 with respect to the investment in the Company (assuming the SPE allocates such credits to that Hawaii Investor); provided that each Hawaii Investor files its own tax return. If the two Hawaii Investors file a consolidated return, the $2,000,000 investment limitation is determined at the consolidated level. Correspondingly, however, if SPE instead invests $5,000,000 in the Company, each of the two Hawaii Investors filing separate returns is still

limited to $2,000,000 with respect to such investment. Any amount of credit in excess of $2,000,000 per annual indirect investment in the Company allocated to a Hawaii Investor would be lost. Further, no credit is allowed with respect to that "surplus" investment in future years.

Consolidated Authorized Insurer Investors

Provided that each authorized insurer investor files a separate return for Hawaii gross premiums tax purposes, each investor that is a member of the same consolidated group of corporations, or under common control, for Federal income tax purposes, is entitled to a separate maximum $2,000,000 investment tax credit against gross premiums tax. Section 431:7-202, HRS, imposes on "[e]ach authorized insurer" a tax of 4.265% on such insurer's gross premiums. Section 431:1-202 defines "insurer" as "every person engaged in the business of making contracts of insurance and includes reciprocal or interinsurance exchanges." Chapter 431 does not provide for the filing of consolidated gross premiums tax returns.

Thus, any Hawaii Investor that is an authorized insurer, subject to the gross premiums tax and liable for tax in Hawaii, is eligible for an investment tax credit of up to $2,000,000 against gross premiums tax with respect to an investment in the Company, even though it may file consolidated Federal income tax returns, or be under common control with, another investor that is also allocated a tax credit of $2,000,000 for its investment in the Company. Correspondingly, however, those Hawaii Investors that are consolidated taxpayers for Hawaii income tax purposes and are not subject separately to the gross premiums tax will be limited to a combined investment tax credit of only $2,000,000, notwithstanding their separate investments in the Company.

Timing of Investment Credit Claims Generated by Indirect Investments

Where an investment is made indirectly through a pass-through entity that is on a different taxable year cycle from the taxpayer to whom investment tax credits are allocated (e.g., where the pass-through entity's taxable year ends June 30 while the investor-taxpayer's taxable year ends December 31), the credit may be utilized by the investor-taxpayer in a manner consistent with general income tax principles including Treas. Reg. l.706-1(a)(1) ("In computing taxable income for a taxable year, a partner is required to include the partner's distributive share of partnership items. . . for any partnership taxable year ending within or with the partner's taxable year.")

Allocation of Investment Credits

Subject to the restrictions of Act 178 (2009), investment tax credits may be allocated on an annual basis (*i.e.*, credits derived from a qualifying investment which are allocated to taxpayers in a certain manner in the first year may be allocated in a different manner in the second, third, fourth, and/or fifth years in which the credits may be claimed subject to the limitations on the total credit that may be claimed by a taxpayer in such year(s) with respect to the investment). All such reallocations must meet the requirements of Internal Revenue Code §

704. The Department reserves all rights to challenge such reallocations for business purpose and economic substance.

Additional Investments in Subsequent Tax Years

Additional and new investments made in the Company by existing and/or new investors before the sunset of § 235-110.9, HRS, will generate an additional investment tax credit attributable to such new investment, provided that the Company continues to qualify as a qualified high technology business under §235-110.9, HRS, and subject to any limitations contained therein.

A. The Company's presence in Hawaii

The Company, a limited liability company, will maintain an office in Hawaii. Therefore, for purposes of §235-110.9, HRS the Company meets the requirement that it employ or own capital or property or maintain an office in Hawaii.

B. The Company's qualified research activities

The term qualified research" means:[6]

(1) The same as in §41(d), Internal Revenue Code (IRC);
(2) The development and design of certain computer software;
(3) Biotechnology;
(4) Performing arts products;
(5) Sensor and optic technologies;
(6) Ocean sciences;
(7) Astronomy; or
(8) Nonfossil fuel energy-related technology.

(1) The same as in §41(d), 1RC

Item (1) of the definition of qualified research above is drawn from IRC §41(d), where it is defined as research undertaken to discover information technological in nature, which constitutes a process of experimentation relating to a new or improved function, performance, reliability, or quality.

"Qualified research" activities must satisfy the following tests under Treasury Regulation § 1.41-4:

(a) The expenditures must qualify as research and experimental expenditures under IRC § 174;
(b) The expenditures must relate to research undertaken to discover information that

[6] §235-110.9, HRS, incorporates the definition of "qualified research" in §235-7.3, HRS.

is both technological in nature and the application of which is intended to be useful in developing a new or improved business component of the taxpayer;[7] and

(c) Substantially all of the activities of the research must constitute elements of a process of experimentation.[8]

§41(d), IRC, further clarifies that qualified research does not include any research:

(a) Conducted after the beginning of commercial production of the business component;
(b) Related to the adaptation of existing business components;
(c) Related to the reproduction of existing business components;
(d) Surveys, studies, market research, etc.;
(e) Conducted outside of the United States;
(f) In the social sciences, arts, or humanities; or
(g) To the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

---

[7] Treasury Regulation §1.41-4(a)(3)(i) provides that "[r]esearch is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component." Treasury Regulation § 1.41-4(a), defines the term "discovering information" to mean research "undertaken for the purpose of discovering information which is technological in nature." For purposes of section 41(d), IRC, information is technological in nature "if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science." The issuance of a patent by the Patent and Trademark Office under the provisions of section 151 of title 35, United States Code (other than a patent issued under § 171 of Title 35, United States Code) constitutes conclusive evidence that the "discovering information" test under Treasury Regulation §1.41-4(a)(3)(i) has been met.

[8] Treasury Regulations further define a *process of experimentation* as "a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involves the identification of uncertainty concerning the development or improvement of a business component, the identification of one or more alternatives intended to eliminate that uncertainty, and the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology). A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative. A taxpayer may undertake a process of experimentation if there is no uncertainty concerning the taxpayers capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayers research activities. Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation."

The *substantially all* requirement is satisfied only if 80% or more of the research activities measured in cost or other consistently applied reasonable basis constitutes elements in a process of experimentation.

Hawaii's law conforms to the federal definition of "qualified research" as set forth in §41(d) IRC, and the accompanying Treasury Regulations. Thus the Company's activities must meet the federal standards of "qualified research" to be classified as such under Hawaii law.

If some of the work is funded by grant, contract, or otherwise by another person or governmental entity, to the extent the work is funded, the requirements of item (1) of qualified research are not met unless the Company retain substantial rights to their research, as defined in §1.41-4A(d)(2), Treasury Regs., and the funding is contingent upon the success of the research. §1.41-4A(d)(1), Treasury Regs.

Where a taxpayer bears the risk of loss with respect to a research project, the project will not otherwise be deemed to be funded and, thus, non-qualifying under §41(d), IRC. *See Fairchild Indus., Inc. v. U.S.,* 71 F.3d 868, 873-74 (Fed. Cir. 1995) ("The statute is designed so that those who bear the risk of financial loss can include the tax credit in their calculation of investment risk.") The Company must also retain "substantial rights to its research." *See* §l.4l-4A (D)(2), Regs. *See Lockheed Martin Cow. v. U.S.,* 85 A.F.T.R.2d 2000-1495, 1502 (Fed. Cir. 2000).

Thus, the Company states that it is involved in activities that meet the requirements of §41(d), IRC. In Part I of the Questionnaire, the Company checked the box indicating that it performs research as defined in §41(d), IRC. By checking this box, the Company represents the following:

- The Company performs research as defined in §41(d), IRC;
- The Company is developing or improving a business component;
- The Company is employing an evaluative process designed to eliminate uncertainty concerning a new or improved function, the performance, the reliability, or the quality of that business component.
- The Company's research activities regarding that business component fundamentally rely on principles of the physical or biological sciences, engineering, or computer science;
- The planned component is not in commercial production; is not adapting or reproducing existing business components; and is not performing surveys or market research; and
- The Company's work is not in the social sciences, arts, or humanities and is not funded by any grant, contract, or otherwise by another person or governmental entity.

Based solely upon the Company's representations contained in this letter, the Company performs research as defined in § 41(d) of the Internal Revenue Code.

(3) Biotechnology

Item (3) of the definition of "qualified research" includes biotechnology. Biotechnology is defined in §235-1, HRS, as the "fundamental knowledge regarding the function of biological systems from the macro level to the molecular and subatomic levels that has application to development including the development of novel products, services, technologies, and subtechnologies from insights gained from research advances that add to that body of fundamental knowledge."

In Part I of the questionnaire, the Company checked the box indicating that it is does qualified research in the field of biotechnology. By checking this box, the Company represents that it meets the requirements of item (3) of qualified research. Specifically, the Company conducts biological research projects in the fields of [REDACTED TEXT]. It will engage in molecular genetic work with respect to [REDACTED TEXT] and will be developing and advancing the technology to [REDACTED TEXT]. Experiments will be conducted on [REDACTED TEXT] to improve [REDACTED TEXT]. Work will be done on [REDACTED TEXT]. Based solely on the representations in this letter, the Company performs qualified research pursuant to the requirements of Item (3).

C. Activity Test

Under §235-110.9, HRS, a company is a QHTB if it meets one of two tests. Under the Activity Test, a company is a QHTB if more than 50% of its total business activities is qualified research and more than 75% of such qualified research is conducted in Hawaii. Under the Income Test, a company is a QHTB if more than 75% of its gross income is derived from qualified research and from either (i) products sold from, manufactured in, or produced in Hawaii, or (ii) services performed in Hawaii.

The Company has represented that it will meet the Activity Test because it will maintain a Hawaii office, more than 50% of its activities will be in qualified research and more than 75% of those qualified research activities will be conducted in Hawaii. In making this determination, the Company used a numerator that contained the costs of activities in direct support of qualified research and a denominator that included all costs for all activities.[9]

Based on the Company's representations in this letter, the Company will be a QHTB, and investments in the Company will qualify for the high technology business investment tax credit if the activities of the Company are substantially as represented.

Pursuant to Announcement 2008-07, the Department makes no determination as to whether the Company qualifies under the Gross Income Test.

[9] "Business activities" are measured by the cost of these activities, the time spent on these activities, or other consistently applied reasonable basis. This is based upon general principles in the income tax and general excise tax law.

D. Credit Recapture

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

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

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

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

In the case of indirect investments made in the Company through SPE, recapture relative to the indirect investor would be triggered under items (B) and/or (C) of §235-110.9(d), HRS, for instance, when either the Hawaii Investors sell their interest or withdraw their investment in SPE. Where recapture is triggered, 10% of the amount of the total tax credit actually claimed by each of the selling or withdrawing taxpayers in each of the two taxable years prior to the year in which recapture occurs is to be added to such taxpayers' tax liability for the taxable year in which the recapture occurs. Such sale or withdrawal, however, will not affect the ability of SPE to allocate any remaining tax credits in the year of the recapture (to the extent not already claimed by the transferor-taxpayer) and in subsequent years among the continuing and substituted investors, provided that SPE still owns equity in the Company and the Company maintains its QHTB status.

Section 235-110.9(d), HRS, provides only for recapture of claimed credits, not the elimination of unclaimed credits. As a practical matter, however, unclaimed credits would be eliminated under either item (1) or (3) above; under (1) because credits may no longer be claimed once the business fails to qualify as a QHTB and under (3) to the extent there is no longer an "investment" from which credits can be generated once the investment is withdrawn from the QHTB. On the other hand, under item (2), credits unclaimed as of the date of the transfer are not extinguished but follow the transferred interest and may be claimed by the transferee, so long as the Company qualifies as a QHTB and the investment associated with the transferred interest remains in the QHTB.

Thus, a credit claimed for a taxable year during which there is a change in ownership of

SPE resulting from the sale or exchange of a Hawaii Investor's membership interest in SPE may be allocated by SPE in any manner of its choosing between the continuing or substituted Unit holders, subject to partial recapture of the credit already claimed by the transferor-member pursuant to §235-110.9(d), HRS. On a going-forward basis, the transferee of the Units is permitted to step into the shoes of the transferor with respect to any remaining tax credit (including the tax credit allowable for the year of the transfer), which may be allocated in respect of such transferor's interest. Credits allowable in a year prior to the years of the transfer which were unclaimed but carried-forward by the transferor, however, remain with the transferor; and the transferee may not claim a credit with respect to such carry-forward. The conclusions drawn in this paragraph relate to sales or exchanges of a Hawaii Investor's membership interest in SPE and not instances of QHTB mergers or acquisitions.

E. Annual Survey

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

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

Pursuant to §235-7.3, HRS, an income tax exclusion is available for income received by an individual or a QHTB as royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of a QHTB.[10] The exclusion may be claimed by the individual or QHTB that owns the patents, copyrights, or trade secrets.

For purposes of the royalty income exclusion, a QHTB is defined as a business conducting more than 50% of its activities in qualified research."[11]

The term "qualified research" means:

(1) The same as in §41(d), IRC;
(2) The development and design of computer software for ultimate commercial sale, lease, license or to be otherwise marketed, for economic consideration. With respect to the software's development and design, the business shall have substantial control and retain substantial rights to the resulting intellectual property;

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

(3) Biotechnology;
(4) Performing arts products;
(5) Sensor and optic technologies;
(6) Ocean sciences;
(7) Astronomy; or
(8) Nonfossil fuel energy-related technology.

The Company meets the requirements of items (1) and (3) in the definition of "qualified research" based upon the discussion in Part I relating to the high technology business investment tax credit. Based on the Company's representations in this letter, more than 50% of the Company's activities will be in qualified research. Based on these facts, royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of the Company received by an individual[12] or a qualified high technology business are excluded from income tax. Furthermore, as long as the Company is a QHTB for purposes of § 235-7.3, HRS, each member's allocated portion of royalties and other income derived from patents, copyrights, and trade secrets owned by the Company and developed and arising out of a QHTB may be excluded from income tax by the members of the Company (and, ultimately, the members of the SPE, *e.g.*, the Hawaii Investors, to the extent the SPE is treated as a partnership for tax purposes) because the Company (and the SPE) will be treated as a partnership for income tax purposes.

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

Section 235-9.5, HRS, provides an exclusion for "all income earned and proceeds derived from stock options or stock," including stock issued through the exercise of stock options or warrants, from a QHTB or from a holding company of a QHTB[13] by an employee, officer, or director of the QHTB, or investor who qualifies for the high technology business investment tax credit in §235-110.9, HRS, effective for taxable years beginning after December 31, 2000. This exclusion is applicable to dividends from stock or stock received through the exercise of stock options or warrants, the receipt or the exercise of stock options or warrants, and income from the sale of stock, including stock issued through the exercise of stock options or warrants.[14]

For entities other than corporations, Act 221, Session Laws of Hawaii 2001, added the following language to §235-9.5. HRS: "similar provisions shall apply to options to acquire

[12] The performing arts product exclusion in §235-73, HRS, is applicable to the author and assignors, licensors, and licensees.

[13] A holding company of a QHTB means any business entity that possesses:
(l) At least eighty per cent of the total voting power of the stock or other interest; and
(2) At least eighty per cent of the total value of the stock or other interest in the qualified high technology business.

[14] §165, IRC, is operative for Hawaii income tax purposes and applies to losses sustained from the sale of stock issued through stock options or warrants granted by a QHTB. *See* §235-2.4(d), HRS.

equity interests and to equity interests themselves with regard to entities other than corporations." With respect to a limited liability company treated as a partnership for income tax purposes, the exclusion is applicable only to the gain from the sale of membership interest units effective for taxable years beginning after December 31, 2000.

For purposes of this income tax exclusion, a QHTB means the same as defined in §235-7.3, HRS, relating to the income tax exclusion for royalties.

The Company meets the requirements of items (1) and (3) in the definition of "qualified research" based upon the discussion in Part I relating to the high technology business investment tax credit. Based on the Company's representations in this letter, more than 50% of the Company's activities will be in qualified research.

Based on these facts, if the Company is taxed as a corporation, the dividends from stock or stock received through the exercise of stock options or warrants, the receipt or the exercise of stock options or warrants, and income from the sale of stock, including stock issued through the exercise of stock options or warrants, issued by the Company or a holding company of the Company received by an employee, officer, director, or investor (who qualifies for the high technology business investment tax credit) are excluded from income tax. If the Company is treated as a partnership for income tax purposes, the section 235-9.5, HRS exclusion is applicable only to the gain from the sale of membership units.

IV. Tax credit for research activities

The tax credit for research activities in Hawaii provided under §235-110.91, HRS, is similar to the federal credit for increasing research activities under §41, IRC. The Hawaii credit is available for tax years 2000-2010 for research done in the State. Unlike the federal credit, the Hawaii credit may be claimed without increasing research expenses for tax years 2001 to 2010 and the 20% Hawaii credit is refundable (the federal credit is nonrefundable).

As discussed in Part I of this letter, Hawaii tax law conforms to the federal definition of "qualified research" as set forth in §41(d), IRC, and accompanying Treasury Regulations. For the same reasons discussed in Part I of this letter the Company is eligible for the Hawaii tax credit for its research activities conducted in Hawaii.

V. Miscellaneous Provisions

Act. 221, SLH 2001, provides additional tax incentives, which are not dependent on the Company qualifying as a QHTB.

- **Technology infrastructure renovation tax credit.** A nonrefundable income tax credit of 4% of the "renovation costs" for each commercial building located in Hawaii is available for tax years 2001 through 2010. "Renovation costs" means costs incurred after December 31, 2000, to plan, design, install, construct, and purchase technology-enabled infrastructure equipment to provide a

commercial building with technology-enabled infrastructure. Act 178, Session Laws of Hawaii 2009, also limits this credit to 80% of the taxpayer's tax liability for renovation costs incurred on or after May 1, 2009 and on or before December 31, 2010.

- **Expanded related entities exemption.** The related entities exemption which exempts from the general excise tax (GET) amounts received, charged, or attributable for "services" or interest between one "related entity" and another "related entity" is expanded. The use of computer software and hardware, information technology services, and database management between related entities is exempt from the GET. These changes are applicable to gross income or gross proceeds received beginning July 1, 2001.

CONCLUSION

Based solely on the information and representations contained in this letter, the Company qualifies for:

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

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

3. If the Company is taxed as a corporation, the income tax exclusion for income earned and proceeds derived from stock options or stock, including income from dividends from stock or stock received through the exercise of stock options or warrants, the receipt or exercise of stock options or warrants, and the sale of stock options or stock, including stock issued through the exercise of stock options or warrants, under §235-9.5, HRS is applicable. If the Company is treated as a partnership for income tax purposes, the section 235-9.5, HRS exclusion is applicable only to the gain from the sale of membership units;

4. The tax credit for research activities under §235-110.91, HRS; and

5. Other miscellaneous tax provisions.

With respect to the investment tax credit allowed under § 235-110.9, HRS, the credit may be allocated to those interest holders in the SPE in a manner consistent with Section I, subject to the transferability and recapture rules addressed in Section I.D.

This ruling is applicable only to the Company and the SPE, and shall not be applied retroactively. It may not be used or cited as precedent by any other taxpayer, and is based on our understanding of the facts that you have represented, and only apply if the amount of cash investments received by the Company does not exceed $3,700,000. In the event that the Company finds it necessary to increase the amount of investment monies to be obtained which

qualifies for the high technology business investment tax credit, the Company shall submit a supplemental ruling request to the Department. No user fee shall be assessed on such supplemental ruling request. If it is later determined that our understanding of these facts is not correct, the facts are incomplete, or the facts later change in any material respect, the conclusion in this letter will be modified accordingly. This ruling also may be subject to change due to future amendments to laws, rules, or official Department positions.

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

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

Very truly yours,

JOSEPH B. TICHY
Administrative Rules Specialist

EXHIBIT A

[REDACTED TEXT]