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LETTER RULING NO. 2010-10

April 27, 2010

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

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

Dear [REDACTED TEXT]:

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

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

1. The high technology business investment tax credit under § 235-110.9, Hawaii Revised Statutes ("HRS");
2. The income tax exclusion for royalties and other income derived from patents, copyrights, and trade secrets received by an individual or a QHTB and developed and arising out of a QHTB under § 235-7.3, HRS;
3. The income tax exclusion for stock options, dividends from stock, the receipt of the options, the exercise of the options, and income from the sale of the options under § 235-9.5, HRS; and
4. The tax credit for research activities under § 235-110.91, HRS.

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

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SHORT ANSWER

Based on the information in your request for a high tech comfort ruling, the questionnaire, “Does a Company Qualify for Hawaii Tax Incentives?” (“Questionnaire”), and the representations made by the Company as stated below in this letter (the “Representations”), the Company will meet the definition of a qualified high technology business as defined in both §235-7.3, HRS and §235-110.9, HRS.

Based solely on the Representations: (1) the Company qualifies as a QHTB for purposes of the tax benefits identified above in Paragraph 1; (2) the patents, copyrights, or trade secrets developed and arising out of the Company will qualify for the tax benefits identified above in Paragraph 2; and (3) income earned and proceeds derived from stock options, stock, options to acquire equity interests, or equity interests in the Company will qualify for the tax benefits identified above in Paragraph 3; provided that the cash investments received by the Company do not exceed \$1,850,000.

The Company also qualifies for other miscellaneous income tax and general excise tax provisions.

FACTS REPRESENTED BY THE COMPANY

The Company makes the following representations:

The Company will record live performances of various musical performances from a variety of *genres* that will be produced in Hawaii. The live recordings will be reduced to tangible form for purposes of being perceived by or through a computer, including compact disc (CD) audio recordings and digital video disc (DVD) audio-video recordings.

The Company intends to record a wide variety of independent live performing arts performances. Some of the independent performances that the Company will record include [REDACTED TEXT] and any other genre of music or performing arts where a market exists for the distribution of live performance recordings. The Company will produce the recordings of these productions in Hawaii with the assistance of its capable performing arts product production staff. The venues that the Company intends to record performances at will include a variety of locations such as [REDACTED TEXT] and other locations throughout the State where such live performances regularly occur.

The Company represents that it is not in the business of producing the live performances themselves. The Company does not produce live performances, which themselves do not constitute performing arts products. Specifically, the Company’s business model is such that the Company produces the recording, including all technical and artistic involvement therein,

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capturing the live performance that will be entirely produced independent of the Company's product. Stated another way, the Company, after learning that an independent live performance will occur, will contract with the live performance producers and talent for the permission and rights to reproduce the live performance for recording on CD or DVD for subsequent sale, lease, or license.

The Company will hold the recordings it produces for sale and license to independent television networks, airline in-flight programs, and sale of CDs and DVDs in exchange for monetary consideration.

Recordings will be both audio and audio-video and will be sold and licensed in multiple media markets. The productions will emphasize that they were performed and recorded in Hawaii and the video productions will include scenes of Hawaii. The Company believes that these productions will promote both the State and its cultural institutions.

[REDACTED TEXT]

The Company will pay license fees to the performing arts organizations and the talent where necessary for the privilege or recording the concerts that the Company will record. The fees will be negotiated by the Company with the performing arts organizations and the artists at arms'-length and the amounts paid will therefore represent a fair market value for the privilege of recording concerts. The fees paid will not exceed fifty percent of the Company's revenues and funds raised from investors and contributions made by members of the Company. Under copyright law, because the right to reproduce the live performance is a right as to the artist, it is fundamentally necessary from both legal and practical business purposes to obtain these permissions in advance in order to properly exploit the content of the live performance. As such, the Company will be entering into various arms'-length licensing contracts for the right to record and reproduce these performances as part of the Company's business activities.

LAW AND ANALYSIS

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

I. High technology business investment tax credit

For investments made in taxable years beginning after December 31, 2000, but before taxable years beginning after December 31, 2010, a nonrefundable high technology business

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investment tax credit of up to \$2,000,000 per taxpayer is available.¹ The credit is graduated over five years (35% to 10%) from the date of the “investment”² in a QHTB for investments made in tax years 2001 through 2010.³ The credit is capped at varying amounts (\$700,000 in the year the investment is made to \$200,000 in the last year).

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 &*

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

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

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.

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

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

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

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

- (1) More than 50% of its total business activities must be qualified research and more than 75% of its qualified research must be conducted in Hawaii (the “Activity Test”); or
- (2) More than 75% of its gross income must be derived from qualified research and the income from this qualified research must be received from:
 - (a) Products sold from, manufactured in, or produced in Hawaii; or

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(b) Services performed in Hawaii (the “Gross Income Test”).⁴

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

- (1) The contract must be entered into before the performance of the qualified research activity;
- (2) The contract requires the Company to bear the expense of the research even if the project is unsuccessful;
- (3) The contract provides that the research is to be performed on behalf of the Company and the Company will have substantial rights to the research results⁵; and
- (4) The contract provides that the company performing the research will not claim the Hawaii qualified high technology business investment credit under HRS §235-110.9 or the Hawaii tax credit for research activities under HRS §235-110.91 for the activities performed on behalf of the Company.

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

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

A. The Company's presence in Hawaii

The Company, a domestic limited liability company organized under the laws of [REDACTED TEXT], represents that it maintains 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.

⁴ This definition of a QHTB for purposes of § 235-110.9 differs from the definition of a QHTB in § 235-7.3, HRS, which is discussed in Part II of this letter.

⁵ If the Company receives a license, the term of the license must be for the useful life of product(s) or research.

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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.

Item (4) Performing arts products

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

- (1) Audiofiles, video files, audiovideo files, computer animation, and other entertainment products perceived by or through the operation of a computer; and
- (2) Commercial television and film products for sale or license, and reuse or residual fee payments from these products.

The Company will record live performances of various musical performances from a variety of *genres* that will be produced in Hawaii. The live recordings will be reduced to tangible form for purposes of being perceived by or through a computer, including compact disc (CD) audio recordings and digital video disc (DVD) audio-video recordings. The Company will hold the recordings it produces for sale and license to independent television networks, airline in-flight programs, and sale of CDs and DVDs in exchange for monetary consideration.

Based solely on the Representations, the Company performs qualified research pursuant to the requirements of Item (4).

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

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C. Activity Test and Gross Income Test

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

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

The Company represents that it will meet the Activity Test because more than 50% of its activities will be in qualified research and more than 75% of those qualified research activities will be conducted in Hawaii. In making this determination, the Company used a numerator that contained the costs of activities in direct support of qualified research and a denominator that included all costs for all activities.⁷ Furthermore, as to the requirement that 75% of the qualified research activities be conducted in Hawaii, the Company used a numerator that contained all costs incurred in direct support of qualified research activities conducted in Hawaii and a denominator that contained all costs incurred for all qualified research activities. In making these representations about the Activity Test, the Company understands that the following activities do not count as qualified research activities for purposes of this test:

- Activities associated with research that is funded by grants and in which the Company has no substantial risks and rights;
- Activities associated with research being performed by the Company pursuant to a contract in which the contract requirements discussed in Part I, above, have been met in favor of another party to the contract; and

⁷ “Business activities” may be measured by the cost of these activities, the time spent on these activities, or another consistently applied reasonable basis. This statement is based upon general principles in the income tax and general excise tax law. Whatever the measure adopted by the taxpayer, the measure must reasonably reflect business realities.

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- Activities performed by another business on behalf of the Company where the contract requirements discussed in Part I, above, have not been met in favor of the Company.

With regards to the Company's license fees, the Company will pay license fees to the performing arts organizations and the talent where necessary for the privilege of recording the concerts. The fees will be negotiated by the Company with the performing arts organizations and artists at arms'-length and the amounts paid will therefore represent a fair market value for the privilege of recording concerts. The fees paid will not exceed fifty percent of the Company's revenues and funds raised from investors and contributions made by members of the Company.

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

D. 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.

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E. Credit Allocation

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

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

Pursuant to § 235-7.3, HRS, an income tax exclusion is available for income received by an individual or a QHTB⁸ as royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of a QHTB.⁹ 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.”¹⁰

As discussed in Part I, relating to the high technology business investment tax credit, the Company, based on the Representations, meets the requirements of Item (4) in the definition of "qualified research." The Company also represents that more than 50% of the Company's activities are in qualified research, again using a numerator that contained the costs of qualified research activities and a denominator that included all costs for all activities. Based on the Representations, royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of the Company received by an individual¹¹ or a QHTB may be excluded from income tax. Furthermore, as long as the Company is a QHTB for purposes of § 235-7.3, HRS and treated as a partnership for income tax purposes, each member's allocated portion of royalties and other income derived from patents, copyrights, and trade secrets owned by the Company and developed and arising out of a QHTB may be excluded from income tax by the members of the Company.

⁸ If the QHTB receiving the income is treated as a partnership for income tax purposes, then the partners or members of the QHTB may exclude the allocated portion of such income, even if the partner or member excluding the income is not an individual or QHTB.

⁹ Expenses for royalties and other income derived from any patents, copyrights, and trade secrets by an individual or a QHTB as defined in § 235-7.3, HRS, are deductible. *See* § 235-2.4(g), HRS.

¹⁰ The definition of a QHTB in § 235-7.3, HRS differs from the definition of a QHTB in § 235-110.9, HRS, which is discussed in Part I of this letter.

¹¹ The performing arts product exclusion in § 235-7.3, HRS, is applicable to the author and assignors, licensors, and licensees.

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

Section 235-9.5, HRS, provides an exclusion for “all income earned and proceeds derived from stock options or stock,” including stock issued through the exercise of stock options or warrants, from a qualified high technology business or from a holding company of a qualified high technology business¹² by an employee, officer, or director of the qualified high technology business, or by an 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, options, or stock, including stock, issued through the exercise of stock options or warrants.¹³

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 equity interests and to equity interests themselves with regard to entities other than corporations.” With respect to a sole proprietorship or a limited liability company treated as a sole proprietorship for income tax purposes, the exclusion provided by §235-9.5, HRS, does not apply. With respect to a partnership or a limited liability company treated as a partnership for income tax purposes, the exclusion is applicable only to the gain from the sale of membership interest units effective for taxable years beginning after December 31, 2000.

The Company meets the requirements of Item (4) 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, more than 50% of the Company’s activities are 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

¹² A holding company of a qualified high technology business means any business entity that possesses:

- (1) At least eighty per cent of the total voting power of the stock or other interest; and
- (2) At least eighty per cent of the total value of the stock or other interest in the qualified high technology business.

¹³ §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 qualified high technology business. See §235-2.4(d), HRS.

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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. Miscellaneous Provisions

The law 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.

V. Conclusion

Based solely on the Representations, the Company qualifies for:

1. The high technology business investment tax credit under §235-110.9, HRS;
2. The income tax exclusion for royalties and other income derived from patents, copyrights and trade secrets received by an individual or a QHTB and developed and arising out of a QHTB under §235-7.3, HRS;
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

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purposes, the section 235-9.5, HRS exclusion is applicable only to the gain from the sale of membership units; and

4. Other miscellaneous tax provisions.

This ruling is applicable only to the Company, and shall not be applied retroactively. It may not be used or cited as precedent by any other taxpayer, and is based on our understanding of the facts that you have represented, and only apply if the amount of cash investments received by the Company does not exceed \$1,850,000. 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

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EXHIBIT A

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