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April 28, 2010

LETTER RULING NO. 2010-11

[redacted text]

Re: Application of certain tax incentives regarding [redacted text]

Dear [redacted text]:

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

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

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

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

SHORT ANSWER

Based on the information in your request for a high tech comfort ruling, the questionnaire, "Does a Company Qualify for Hawaii Tax Incentives?" ("Questionnaire"), and the representations made by the Company as stated below in this letter (the "Representations"), the Company will meet the definition of a qualified high technology business as defined in both § 235-7.3, HRS and § 235-110.9, HRS, provided the amount of cash invested in the Company does not exceed \$1,000,000.

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

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

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

FACTS REPRESENTED BY THE COMPANY

The Company makes the following representations:

The Company is a Hawaii business engaged in the field of biotechnology. Specifically, [redacted text]

The Company will apply the efforts of such research to develop new technology to diagnose, prevent, and treat [redacted text]. The research will also be distributed to independent researchers and pharmaceutical companies to further develop new technology related to [redacted text] prevention, diagnosis and treatment.

The Company will catalogue all research data in a [redacted text], which will be owned by the Company. The data collection will include [redacted text]. Potential customers [redacted text] will be able to browse the types of available [redacted text] data via a secure Company webpage. Data samples will be organized by varying characteristics; and specific characteristics will be searchable and itemized for customers. Customers will be able to purchase [redacted text] research data from the Company. [redacted text]

[redacted text]

The Company is a Hawaii limited liability company that will be treated as a partnership for federal income tax purposes. The Company is seeking up to \$1 million of cash investments from third-party investors in its initial round of outside financing.

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

LAW AND ANALYSIS

The requirements for these tax incentives and their application to the Company and related taxpayers 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

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five years (35% to 10%) from the date of the “investment”¹ in a QHTB. The credit is capped at varying amounts (\$700,000 in the year the investment is made to \$200,000 in the last year). Some of the credit claimed will be recaptured in certain circumstances. See Part I.D., below.

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

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

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

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 “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.

² 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.

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

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.

A. The Company's presence in Hawaii

The Company, a limited liability company, represents that it maintains its office in [redacted text], Hawaii.

B. The Company's qualified research activities

The term "qualified research" means:⁴

- (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 (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

³ If the Company receives a license, the term of the license must be for the useful life of product(s) or research.

⁴ Section 235-110.9, HRS, incorporates the definition of "qualified research" in § 235-7.3, HRS.

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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 involved in biotechnology. By checking this box, the Company represents that it meets the requirements of item (3) of qualified research.

Specifically, [redacted text].

The Company represents that its research efforts are undertaken to discover information that is technological in nature in that the processes of experimentation used fundamentally rely on principles of science. The Company's research seeks to support the expansion and refinement of common knowledge of skilled professionals with respect to [redacted text], and that expansion of common knowledge will lead to the development of new and improved [redacted text].

Based solely on the Representations, the Company performs qualified research pursuant to the requirements of Item (3).

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 is maintaining an office in Hawaii.

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

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included all costs for all activities.⁵ 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
- 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.

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 (3) 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.

⁵ "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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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.

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 QHTB⁶ as royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of a QHTB.⁷ 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.”⁸

As discussed in Part I, relating to the high technology business investment tax credit, the Company's representations meet the requirements of item (3) 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 individual⁹ or a QHTB may be excluded from income tax. Furthermore, as long as the Company is a QHTB for purposes of § 235-7.3, HRS and treated as a partnership for income tax purposes, each member's allocated portion of royalties and other income derived from patents, copyrights, and trade secrets owned by the Company and developed and arising out of a QHTB may be excluded from income tax by the members of the Company.

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

Section 235-9.5, HRS, provides an exclusion for “all income earned and proceeds derived from stock options or stock,” including stock issued through the exercise of stock options or

⁶ 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.

⁷ 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.

⁸ This definition differs from the definition of a QHTB in § 235-110.9, HRS, which is discussed in Part I of this letter.

⁹ The performing arts product exclusion in § 235-7.3, HRS, is applicable to the author and assignors, licensors, and licensees.

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warrants, from a QHTB or from a holding company of a QHTB¹⁰ 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.¹¹

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

As discussed in Part I, relating to the high technology business investment tax credit, the Company's representations meet the requirements of item (3) 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 and assuming the Company is treated as a corporation for income tax purposes, the income earned and proceeds derived from stock options, stock, options to acquire an equity interest, or equity interests may be excluded from income tax. However, if the Company is treated as a partnership for income tax purposes, only the gain from the sale of membership interest units may be excluded from income tax.

IV. Conclusion

Based solely on the Representations, the Company qualifies as a QHTB for purposes of the tax benefits identified on the first page hereof in Paragraphs 1, 2, and 3. The conclusions reached in this letter apply only to the extent the amount of cash investments received by the Company do not exceed \$1,000,000.

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.

The conclusions reached in this letter are based on our understanding of the facts that the Company has represented. If it is later determined that our understanding of these facts is not

¹⁰ A holding company of a QHTB means any business entity that possesses:

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

¹¹ Section 165, IRC, is operative for Hawaii income tax purposes and applies to losses sustained from the sale of stock issued through stock options or warrants granted by a QHTB. See § 235-2.4(d), HRS.

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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.

If you have any further questions regarding this matter, please call me at 808-587-5334. Additional information on Hawaii's taxes is available at the Department's website at <http://www.hawaii.gov/tax>.

Sincerely,

Jacob L. Herlitz
Administrative Rules Specialist

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