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TAX INFORMATION RELEASE 2013-02

RE: Department of Taxation Policies Relating to the Hawaii Tax Credit for Research Activities

The purpose of this Tax Information Release is to provide taxpayers and tax professionals with guidance on the Department of Taxation's ("Department") policies regarding its analysis of Act 270, Session Laws of Hawaii 2013 ("Act 270"). In general, Act 270 reenacts the Hawaii Tax Credit for Research Activities ("TCRA") for taxable years from 2013 to 2019. It also adds, amends, and deletes definitions, establishes new reporting requirements, and requires the Department of Business, Economic Development, and Tourism ("DBEDT") to conduct studies to measure the effectiveness of the tax credit and to submit reports to the legislature.

I. Overview of the TCRA and Act 270

The TCRA is intended to encourage taxpayers to design, develop, and/or improve products, processes, techniques, formulas or software and intended to reward programs that pursue innovation. An alternative simplified method allows taxpayers to claim research credits even if research costs remain the same or if costs decline as compared to prior years.

In particular, Act 270 adopts §41of the Internal Revenue Code ("IRC") as of December 31, 2011, with the further requirement that Qualified Research Expenses ("QREs") do not include research expenses incurred outside of the State. If the amount of the credit exceeds the amount of the taxpayer's tax liability (if any) for the applicable tax year, the difference is refunded to the taxpayer.

Significantly, Act 270 adopts the base amount as set forth under IRC §41(c), such that only the increasing incremental amounts are eligible for the credit. Act 270 also requires that in order for a taxpayer to claim the Hawaii TCRA, said taxpayer must also claim the federal tax credit for increasing research activities under IRC §41.

II. Federal TCRA in General

The federal TCRA is an incremental credit based on increases in research activities under IRC §41(a). Taxpayers may choose to claim the credit under the Regular Research Credit ("RRC") method or the Alternative Simplified Credit ("ASC") method under IRC §41(c)(5).

The RRC equals 20% of a taxpayer's current-year QREs that exceed a base amount, which is determined by applying the taxpayer's historical percentage of gross receipts spent on QREs (the fixed-base percentage) to the four most recent years' average gross receipts. The fixed-base percentage may not exceed 16%, and the base amount may not be less than half of the current-year QREs. For taxpayers that had QREs in calendar years 1984 through 1988, this the historical period for determining the fixed-base percentage ("FBP"), which is calculated by dividing the taxpayers aggregate qualified research expenses by the aggregate gross receipts. This FBP is then multiplied by the average of the taxpayer's gross revenue for the 4 years prior to the taxable year to give the base amount. (This FBP only changes for purposes of meeting the consistency rule or adjusting for an acquisition or disposition).

Special rules apply to a "start-up company", which is generally defined as a company that did not have both gross receipts and QREs in at least three of the base period years or began having them after 1988. For further information, please refer to IRC §41(c)(3)(B), which assigns a fixed-base percentage of 3% for each of the first five years which gradually increases to the actual FBP as calculated using any 5 taxable years as selected by the taxpayer among the 5th through 10th taxable years. Spun-off companies may or may not be considered start-up companies for purposes of computing the base amount.

The ASC equals 14% of the QREs for the taxable year that exceed 50% of the average QREs for the three taxable years preceding the taxable year for which the credit is being calculated. If the taxpayer has no QREs in any one of the three preceding tax years, the ASC rate equals 6% of the QREs for the taxable year. The election to claim the ASC must be made on the original tax return, cannot be made retroactively, and is binding on all subsequent years unless formally revoked (with the consent of the Internal Revenue Service ("IRS")). A taxpayer cannot elect or revoke an ASC election on an amended return.

Special rules apply to controlled groups of corporations and trades or businesses and corporations and trades or businesses under common control. Under IRC §41(f)(1) and §1.41-6(b) of the Income Tax Regulations ("Treas. Reg."), all members of a controlled group are treated as a single taxpayer for purposes of computing the research credit. Section 1.41-6(b) provides that the group credit is computed by applying all of the §41 computational rules on an aggregate basis.[1]

[1] IRC§41(f)(1)(A)(ii) and §41(f)(1)(B)(ii) were amended by section 301(c) of the American Taxpayer Relief Act of 2012, P.L. 112-240, H.R. 8 ("ATRA"), for taxable years beginning after December 31, 2011. Former IRC §41(f)(1)(A)(ii) and former IRC §41(f)(1)(B)(ii) provided that the research credit allowable to a controlled group member shall be its proportionate shares of the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums giving rise to the credit. Treas. Reg. §1.41-6(c)(1)(i) requires a controlled group to allocate the group credit in proportion to each member's stand-alone entity credit, as defined in §1.41-6(c)(2), in cases in which the group credit does not exceed the sum of the stand-alone entity credits of all of the members. If the group credit does exceed this sum, then the excess of the group credit over the sum of the stand-alone entity credits of all of the members is allocated in proportion to the QREs of the members of the controlled group. See Treas. Reg. §1.41-6(c)(1)(ii).

Section 301(c) of the ATRA amended IRC §41(f)(1)(A)(ii) and IRC §41(f)(1)(B)(ii) by requiring the allocation of research credits to each controlled group member "on a proportionate basis to its share of the aggregate of the

III. Relationship to IRC §280C(c)

Under IRC §174, a taxpayer may elect either to currently deduct research and experimental expenditures or may capitalize such research and experimental expenditures and amortize them over a period of not less than 60 months. Once a taxpayer chooses a particular method, it may change methods only with IRS permission. A taxpayer that neglects to make the choice is generally required to capitalize research and development without amortization. Act 270 retains conformity to IRC §280C(c) for purposes of the Hawaii TCRA. In general, IRC §280C(c)(1) provides that no deduction is allowed for that portion of QREs (as defined in IRC §41(b)) or basic research expenses (as defined in IRC §41(e)(2)) otherwise allowable as a deduction for the taxable year that is equal to the amount of the credit determined for such taxable year under IRC §41(a). Under subparagraph (2), the same rule applies to capitalized expenses. Alternatively, IRC §280C(c)(3)(A) provides that a taxpayer may make an annual election to take a reduced research credit in lieu of having to decrease the amount of expenses expensed or capitalized. IRC §280C(c)(3)(C) provides that an election under this paragraph shall not be made any later than the time for filing the return for tax for the year the credit is claimed, including extensions[2]. This yearly election is irrevocable once made, and a taxpayer who fails to make a timely election for the reduced research credit under IRC §280C(c)(3)(A) is precluded from making such an election on an amended return and cannot avoid the reduction in otherwise deductible expenses under IRC §280C(c)(1) or (c)(2).

IV. Calculation of the Hawaii TCRA

Act 270 provides that "[t]here shall be allowed to each qualified high technology business subject to the tax imposed by this chapter an income tax credit for qualified research activities equal to the credit for research activities provided by section 41 of the Internal Revenue Code…", with the additional requirement that any such research be conducted in Hawaii.

In order for a taxpayer to compute the amount of the Hawaii TCRA, it is therefore necessary for the taxpayer to compute the amount of the federal TCRA prior to calculating the Hawaii TCRA, since the federal TCRA is the baseline upon which the Hawaii TCRA is measured. Any elections made in computing the amount of the federal TCRA will impact the amount of the Hawaii TCRA. Thus, a taxpayer claiming the Hawaii TCRA will be impacted by whether or not the taxpayer chooses the RRC or ASC method to determine the federal amount of

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qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums, taken into account by such controlled group for purposes of this section." Thus, the amendments to IRC § 41(f)(1)(A)(ii) and IRC § 41(f)(1)(B)(ii) provide that the group credit is allocated to group members based on a member's share of qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums, without regard to whether the member would have a stand-alone entity credit or what the amount of any such credit would be. Section 301(c) of the ARTA applies to taxable years beginning after December 31, 2011.

[2] Treas. Reg. § 1.280C-4(a) provides that the election shall be made on an original return, and "shall be made by claiming the reduced credit . . . on an original return for the taxable year, filed at any time on or before the due date (including extensions) for filing the income tax return for such year." IRC § 280C(c)(3)(C) further provides that such an election, once made, is irrevocable. See Treas. Reg. § 1.280C-4(a).

the credit. Such taxpayer must also reduce their deduction or amortization by the amount of expenses for which they claim a credit, or proportionately reduce their credit according to IRC §280C(c)(3)(B) depending on the method that they have selected (whether by default or otherwise) for federal purposes.

Calculation of the Hawaii TCRA involves a straightforward calculation by multiplying the federal TCRA by a fraction, the numerator of which is the amount of eligible research expenses for research conducted in Hawaii and the denominator of which is the amount of expenses eligible for the federal TCRA. The claim for the Hawaii TCRA is made by attaching to the applicable income tax return Forms N-346 and N-346A (which will be released shortly by the Department), including a copy of federal Form 6765 (Credit for Increasing Research Activities), any schedule K-1s (if applicable), and such other documentation as required by the Department as stated in the Form N-346 instructions.

In the event that the federal TCRA is changed, corrected or adjusted by the IRS, the taxpayer must notify the Department of such change, correction or adjustment. Specifically, Hawaii Revised Statutes ("HRS") §235-101(b) provides:

> It shall be the duty of every person who is required by section 235-92 to make a return, to report to the department, as to any taxable year governed by this chapter, if (1) the amount of taxable income as returned to the United States is changed, corrected, or adjusted by an officer of the United States or other competent authority, or (2) a change in taxable income results from a renegotiation of a contract with the United States or a subcontract thereunder, or (3) a recomputation of the income tax imposed by the United States under the Internal Revenue Code results from any cause, or (4) an amended income tax return is made to the United States. The report shall be made within ninety days after the change, correction, adjustment, or recomputation is finally determined or the amended return is filed, as the case may be. The report required by this subsection shall be made in the form of an amendment of the person's return filed under this chapter. The amended return shall be accompanied by a copy of the document issued by the United States under (1) to (3). The statutory period for the assessment of any deficiency or the determination of any refund attributable to this report shall not expire before the expiration of one year from the date the department is notified by the taxpayer or the Internal Revenue Service, whichever is earlier, of such a report in writing. Before the expiration of this one-year period, the department and the taxpayer may agree in writing to the extension of this period. The period so agreed upon may be further extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

V. Certification of Credit Claims and Required Fees

Act 270 does not alter the previous requirements contained in HRS §235-110.91 that taxpayers[3] provide certain information to the Department on or before March 30th[4] of the

[3] For situations in which the QHTB is an entity taxed as a partnership or other pass-through entity, the Department will allow either the QHTB or the pass-through entity to complete, sign, and file Form N-346A on behalf of all of

calendar year following the taxable year in which the TCRA is claimed[5]. If the QHTB conducting the research fails to submit the required information by the deadline, then no Hawaii TCRA is allowed.

The Department, in turn, must certify the information. The main purpose of certification is to gather information, and as such, the Department does not audit such claims for allowability of the credit at the time of certification. Instead, all claims for the credit are subject to audit notwithstanding certification of the claim. A taxpayer may claim the credit if the investor has a reasonable basis[6] for asserting such claim, but must substantiate the claim if called into question upon audit by the Department.

Act 270 also retains the provision that "[t]he director of taxation may assess and collect a fee to offset the costs of certifying tax credit claims under this section." Previously, the Department assessed a fee for all taxpayers asserting a research credit amount of $25,000 or more. The fee was $400 if the certification request was made before the third Wednesday following the close of the tax year in which the research expenses were incurred, and $750 thereafter.[7] Because the Department anticipates that the number of certification requests will be limited, the Department is imposing a fee of $500.00 per certification request where the Hawaii TCRA is $25,000 or more without regards to when it is submitted to the Department. It should be noted, however, that the deadline for submission by the QHTB remains at March 30th for a calendar year filer since this requirement is set by statute, and any request made after that date will be rejected as untimely.

All claims for the TCRA under HRS §235-110.91 must be filed on or before the end of the twelfth month following the close of the taxable year for which the credit may be claimed. Failure to properly claim the credit shall constitute a waiver of the right to claim the credit. As noted earlier, to properly claim the credit, the taxpayer must attach to the applicable income tax return, all required documentation to support the credit claim, including Forms N-346 and N-346A, copy of federal Form 6765, and any schedule K-1s (if applicable), and such other documentation as requested by the Department.

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the partners/members/shareholders provided that such QHTB or pass-through entity has a signed authorization from the investor at the time of submitting the Form N-346As to the Department, and further provided that such filing is submitted on or before the due date. Such entity must maintain the authorization(s) on file.

[4] HRS §235-110.91(d) provides that "[e]very qualified high technology business, before March 31 of each year in which qualified research and development activity was conducted in the previous taxable year, shall submit a written, certified statement to the director of taxation…." A submission made on March 31 would not be "before March 31" and therefore the deadline is construed to be on or before March 30.

[5] For fiscal year filers, the time deadline is before the end of the third month following the close of the fiscal year. For example, for a fiscal year taxpayer that has a November 30th tax year end, the deadline to provide certain information would be February 28th of the following year.

[6] Note that while an investor/taxpayer may take a tax return position for which there is a reasonable basis, a tax advisor can only advise a taxpayer to take a position for which there is a realistic possibility of its being sustained on its merits. See § 10.34, Treas. Reg. (31 C.F.R.).

[7] See Department of Taxation Announcement no. 2005-19.

VI. Report to the Legislature

Act 270 requires the DBEDT to submit a report to the legislature by September 1 of each year on the following:

a) The amount of tax credits claimed and total taxes paid by Qualified High Technology Businesses ("QHTB");
b) The number of QHTBs in each industry sector;
c) The numbers and types of jobs created by QHTBs;
d) External services and materials procured by the QHTBs;
e) The compensation levels of jobs provided by QHTBs;
f) Qualified research activities; and
g) Any other factors DBEDT deems relevant.

All QHTBs that claim the TCRA must complete and file an annual survey on electronic forms to be prepared and prescribed by DBEDT on or before June 30 of each calendar year following the year in which the TCRA is claimed, which must include the following information (for the time period or periods as specified by DBEDT):

a) Identification of the industry sector or sectors in which the QHTB conducts business, as set forth in paragraphs (2) to (8) of the definition of "qualified research" in HRS §235-7.3 (C) ;
b) Total expenditures and the qualified expenditures, if any, expended in the previous taxable year;
c) Revenue and expense data, including a breakdown of any licensing royalty or other forms of income generated from intellectual property;
d) Hawaii employment and wage data, including the numbers of full-time and part-time employees retained, new jobs, temporary positions, external services procured by the business, and payroll taxes;
e) Filed intellectual property, including invention disclosures, provisional patents, and patents issued or granted; and
f) The number of new companies spun out or established to commercialize the intellectual property owned by the QHTB.

Further information on the required survey will be forthcoming from DBEDT.

V. Effective Date

Act 270 is effective on July 1, 2013, and applies to taxable years beginning after December 31, 2012, and sunsets for taxable years beginning after December 31, 2019. Thus, calendar year taxpayers may claim the TCRA for QREs for the period of January 1 through December 31. Fiscal year filers must wait for a tax year that begins after December 31, 2012 in order to claim the TCRA. For example a fiscal year filer with a tax year that runs from December 1st through November 30th must wait for the tax year beginning December 1, 2013 before

claiming the TCRA. Such a taxpayer would, however, be able to claim the credit for the period December 1, 2019 through November 30, 2020 since Act 270 only sunsets as to taxable years beginning after December 31, 2019.

For more information on this Tax Information Release, please contact the Rules Office at (808) 587-1577.

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HRS Explained: 235-110.91