TAX REVIEW COMMISSION

MINUTES OF THE TWENTYFIRST MEETING OF THE
TAX REVIEW COMMISSION
HELD AT STATE CAPITOL, ROOM 211
IN THE CITY AND COUNTY OF HONOLULU
STATE OF HAWAII, ON WEDNESDAY, OCTOBER 25, 2006

The Commissioners of the Tax Review Commission met at the State Capitol, Room 211, in the City and County of Honolulu, State of Hawaii, on Wednesday, October 25, 2006.

Members Present:
Chairman Isaac Choy, Manoa Consulting Group, LLC CPA's
Vice-Chairman Ronald Heller, Torkildson Katz Fonseca Moore & Hetherington, AAL, ALC
Carolyn Ching, Carolyn L. Ching CPA
Christopher Grandy, UH Manoa, Public Administration Program
Melanie King, Bank of Hawaii
Lon Okada, Hawaiian Electric Industries, Inc.
John Roberts, Niwao & Roberts, CPA's

Staff: Tu Duc Pham, Donald Rousslang, Cathleen Tokishi

Other:
Sarah Akinaka, Senate Majority/Senator Fukunaga
Jeffrey Au, PacifiCap Group
Stanley Baptista, DOTAX
Stephanie Beran, DOTAX
Harry Blanchette, Senate Minority Research Office
R. B. Carleton, Search-SEC.com Inc.
John Chock, Hawaii Strategic Development Corp.
Ann Chung, Hawaii Science & Technology Council
Diane Erickson, Dept. of the Attorney General
Lisa Gibson, Hawaii Science & Technology Council
Sean Hao, Honolulu Advertiser
Craig Hirai, Bowen Hunsaker Hirai
Ed Ikuma, LRB
Pearl Imada Iboshi, DBEDT
Denise Ishikane, Accuity LLP
Mary James, House Majority Research Office
Ray Kamikawa, Chun Kerr Dodd Beaman & Wong
Kurt Kawafuchi, DOTAX
D. Kimura, ESN – Energy Industry
Ian Kitajima, Oceanit
Dew-Anne Langcaon
Theodore Liu, DBEDT

Johnnel Nakamura, DOTAX
Jennifer Nakanishi, Hoku Scientific
Marilyn Niwao, HAPA/Niwao & Roberts, CPAs
Robert Robinson, Hawaii Angels
Bob Shleser, Clear Fuels
Bill Spencer, Hawaii Venture Capital Association
J. Sullivan, Oceanit
Patrick Sullivan, Hoana/Oceanit
Nicki Thompson, Governor's Policy Office
Joseph Tichy, DOTAX
J. Toth, Net Enterprise
David Watumull, Cardax Pharmaceuticals
Betty Wong, DOTAX
Kay Yamada, High Technology Development Corp.
Russell Yamashita

CALL TO ORDER

Chairman Isaac Choy called the meeting to order at 9:05 a.m. with a quorum present.

ANNOUNCEMENTS

Introductions. The Chairman introduced each member of the Commission, and then introduced Ms. Ann Chung, Vice President of the Hawaii Science and Technology Council, who asked for the meeting on behalf of the technology industry and who coordinated the speakers.

PRESENTION BY THE HAWAII SCIENCE & TECHNOLOGY COUNCIL

Ms. Chung began by thanking the Commission for scheduling the meeting to give them an opportunity to present additional information, while recognizing that doing so was not customary.

She then began by addressing "the elephant in the room," which was the previous day's report in the *Honolulu Advertiser* that the potential amount of qualified high technology business (QHTB) investment tax credit could reach $1 billion.

Ms. Chung stated that the number had been a surprise to the industry, and seemed to be overstated given their experience. She asked Dr. Pham how that number was derived. However, the Chairman first asked Ms. Chung if the industry thought that the $1 billion figure was too high or too low. While it would be wonderful if the number were accurate, it was, in her opinion, too high. She agreed with the Chairman's assertion that one would think that the greater the amount of credit claimed the greater the benefit to the State and that she should be happy if that number were even higher, but that the projection should be more conservative and realistic rather than inflammatory. With respect to Ms. Chung's question of Dr. Pham, the Chairman stated that he had not yet had a chance to talk with Dr. Pham about the number that had been prepared for the Council on Revenues rather than for the Tax Review Commission, and that he had directed Dr. Pham to not address her question until he had done so.

Ms. Chung stated that her understanding was that the number had been prepared for the Council on Revenues meeting and that the Council on Revenues had reduced that number. She incorrectly stated that she believed that the Council on Revenues meeting was closed to the public and that some information was unavailable for that reason; however, that statement was later corrected, as it was an open meeting. The Chairman asked Ms. Chung what she thought the actual projection should be. She thought that Director Kawafuchi had said that it was around $600,000, about the same as the number projected by Dr. Marcia Sakai. The Chairman observed that nobody really knows what that number would be. Ms. Chung replied that the number is a variable dependent on how things are going, and that the previous day's report might scare some people away. The industry would like accurate projections.

Ms. Chung then addressed what she termed a mischaracterization promoted in part by the media that the industry doesn't want data collected or an analysis performed. They do want data and they do want an analysis to be done, but they are not given the data. She noted that a reporter had suggested that the industry collect the data to validate the industry's claims. However, the only single source of the confidential tax data is the Department of Taxation.

Data collection should not be a problem since all information needed regarding revenues and jobs company types, and more is at the Department as reported on Forms N-317, N-317A, N-318, and N-318A. The problem is getting that data aggregated to avoid confidentiality issues and getting that data out to the public in a comprehensive form at regular intervals rather than in a piecemeal fashion if at all.

The Chairman, noting that Ms. Chung had told him to ask questions during the presentations and that he was not being rude, asked if she thought that any data should be confidential. She first confirmed that she had encouraged asking questions during the presentations, and then answered by saying that aggregated data was fine, but that the investor names should be kept confidential.

Dr. Grandy asked if the names and investment amounts should be kept confidential if the investors are being allowed to write off their tax. Ms. Chung stated that the investment amounts could be publicized, but not the names because they are taking a risk. Dr. Grandy asked what the risk was if they get the credit. Ms. Chung noted that the company many not be in business next year. However, Dr. Grandy questioned the amount of risk if the alternative was to have no credit. Ms. Chung answered by saying that one purpose of the credit was to change investment behavior. She then turned it over to Mr. Jeffrey Au to address the question.

Mr. Au first thanked the Commission. He stated that it was important to note that while it is a 100% credit over five years, only 35% of credit is claimed in the first year, so investors have to invest 285% of their tax liability to fully offset their tax liability in the first year. For example, if he had $35,000 of tax liability that he wanted to cover with this credit, then he would have to invest $100,000 in the first year to get $35,000 of tax credit. He questioned why he would invest $100,000 just to get $35,000 of tax credit when he could have simply paid the $35,000. It only made sense if he believes that the company would generate a positive return.

During the phase-in, there is always the risk of recapture. In venture capital, companies generally run out of money in 12 months unless you put more money in because the company has no product to sell at that point. Venture capitalists typically don't want to fund more than one year of burn without seeing how the company is doing. They therefore have to put in more money each year. However, even if five years of burn was put in at the beginning, there is the time value of money, which means that the value of the credit is less than full value.

The Chairman asked about the multiples. Mr. Au said that there really are no multiples. The credit is 100% credit over five years. What people call the multiple is really the disproportionate allocation of credits amongst the investors. Credits can then be shifted from taxpayers with no or low tax liability to more risk adverse investors. Those high multiples may therefore eliminate all or most of the risk, and Mr. Au thinks that may be true. However, assertions that the companies must therefore be lousy companies are incorrect, because for every Hawaii investor getting an extra credit allocation there is an investor that is not getting a credit or less credit and taking the full risk. The market takes care of the issue. The multiples are necessary because there are many kinds of investors. Individual investors who may make a bad choice lose their own money but it is not the end of the world. Institutional investors are acting in a fiduciary role and have different priorities. If they make a bad choice they lose their tax budgets and are therefore more risk averse.

The Chairman recalled that Mr. Au had told him that 8 out of 10 deals fail. Mr. Au clarified that in Silicon Valley, venture capitalists would expect that, out of 10 companies, 2-3 would go bankrupt, 2-3 would be "living dead" (i.e., companies that are in business, that may be profitable, may create jobs, tax liability, and lots of economic activity, but have no liquidity event – venture capitalists make their money when the company is sold), 2-3 do well and pay for the rest. He observed that the vast majority of companies in Hawaii are "living dead" as few ever go public. However, this credit can be used to fund these companies even if not typically funded by venture capital because they don't return 10 times the investment. He stated that even bankrupt companies generate wages that result in state revenue in the form of taxes – the venture capitalists don't make money from day one although the State does.

Ms. Chung thanked Jeff, and noted that she has been a lobbyist, and not a tax expert, involved with this credit since the beginning over the seven years since she returned to Hawaii from the mainland. Therefore, the technical questions will go to others.

To provide additional background and context, Ms. Chung introduced Mr. Ray Kamikawa, a former Director of Taxation who was the Director at the time the initial legislation, Act 178, SLH 1999, was enacted. Ms. Chung referred the Commissioners to a 10-page document detailing the history of the credit legislation that was provided to the Commissioners and is included in these minutes as Attachment 1. Five other documents submitted by the Hawaii Science and Technology Council are also included in these minutes as Attachment 2 through Attachment 7.

Mr. Kamikawa stated that he would be providing his first-hand account rather than following the handout that Ms. Chung had prepared. He explained that the credit was born out of a desire to do something tangible to diversify the economy. Many groups had discussed diversifying the economy with much talk of waiting for various other things to be in place before implementing diversification. Instead of doing nothing, they decided to do something bold during a time in the economic cycle when Hawaii was not doing well.

Investment had traditionally been made in real estate, and something needed to be done to jar investors, including banks, from their focus on real estate and to think about investing in businesses with intangible assets such as intellectual property. Intellectual property had the potential for generating lots of money while leveraging Hawaii's scarce resources and taking advantage of Hawaii's unique location in such areas as ocean sciences, sensors and optics, and astronomy.

These types of industries and companies could be good for Hawaii, could hire local, but also have scalability (i.e., locating the company in an environmentally-friendly way but also be able to export service and products to infinity). He noted that manufacturing did not have to be in Hawaii; manufacturing could be done anywhere and the product drop-shipped anywhere in a transaction not subject to the general excise tax (GET).

To get people's attention and accomplish this goal, an incremental approach was not sufficient and they decided to go for a 100% credit, and it passed.

The credit was patterned after the low-income housing tax credit, which is a 10-year 100% credit in which the State piggybacks onto the federal credit and is one of the most successful credits in the country. Accelerating the QHTB investment tax credit to five years and front-loading the credit was necessary to offset the perceived risk of investing in technology companies. At the same time, they wanted to avoid the slow, and largely unknown, bureaucratic government process for applying for an allocation of the low-income housing tax credit. Therefore, Act 221, SLH 2001, was designed to be private-market-friendly by keeping it a private negotiation between the company and the investor.

The disadvantage to this approach is that there is no trade association or some other person collecting data on these transactions to the penny and finding out where the resources and the credits are being deployed. The second-best option is to have a repository for this raw data. This does exist now at the Department of Taxation with all the reporting being required on the Form N-317. He cautions that the data need to be captured in a way that is friendly to analysis.

Mr. Kamikawa next explained that the credit allocation provision was copied from the low-income housing tax credit, which contains a provision that allows a shifting of the credit from nonprofit and mainland taxpayers to Hawaii taxpayers. He thought that it was a good way to generate interest and to match the local Old Economy investors with experienced out-of-state New Economy investors.

Mr. Kamikawa then referred to an article entitled, "Benchmarking," that Ms. Chung provided him with from the *Economic Development Journal*. On page 47, it refers to both direct and indirect job creation, and also to jobs maintained. Ms. Chung noted the increasing number of other service providers, such as attorneys and accountants, who are become more skilled in technology related areas.

Mr. Kamikawa added an increasing tax base, both direct and indirect, as another important benchmark. Other examples provided in the article include loans leveraged, improved corporate performance, linked companies staying in the area, stimulation of new markets or new products, revitalized properties, nontraditional jobs gained, etc.

The Chairman asked why these kinds of benchmarks and adequate Department resources to collect the data and conduct that kind of analysis were not included in the 2001 legislation. Mr. Kamikawa stated that, given the process, it was difficult enough to convey the concept. If it had been suggested to him, and he noted that he had been taking suggestions all session, perhaps it would have been. He believes that this is a grand experiment for Hawaii, and data need to be gathered and distributed on a definitive schedule in a form that everyone has access to.

The Chairman asked which agency should be responsible for this. Mr. Kamikawa stated that the Tax Department should be the responsible agency as it is a tax credit, and that the Department has the power to collect all the information. They just need to put it on the form that can be captured on its systems in a way that can be assembled and reported out.

Dr. Grandy noted that Dr. Marcia Sakai and Dr. Bruce Bird had difficulty getting data, and asked if, for a credit of this type, which, in the words of Mr. Kamikawa, is a grand experiment, it would make sense to have a legislative change to allow the release of the data in a much more timely fashion and whether he would support that. Mr. Kamikawa pointed out that Act 215, SLH 2004, requires a certification procedure with a March 30 deadline. He would have preferred something more helpful in that regard, but he believes that the Department already has the power to require this. Unless a company is gearing up for a reporting of data soon after the close of the year, it is not possible to provide that kind of information in early January. Perhaps it would be possible if reporting was done quarterly, as Ms. Chung had alluded to, as an ongoing requirement. However, January is a very busy month, and the data reporting should be divorced from the tax filing requirement. It could be a glorified Form N-317, but if so, the certification requirement should be repealed.

Mr. Heller noted that there were two parts to getting the information out. One was the Department analyzing the numbers. Assembling and aggregating the data off of the forms takes people and resources. He asked if the Department has the people and resources to do this. The second part was that, even when the Department has data, it is sensitive to the confidentiality of tax return-based information. Even when aggregated, there is still some concern and reluctance to issue it. He asked if additional legislation would be appropriate to deal with that. Mr. Kamikawa stated that he thought that additional legislation should not be needed for the release of aggregated data. However, Mr. Heller's first point is correct, and that the Department may have issues with resources and priorities. Mr. Kamikawa pointed out that the technology industry is not the only sector benefiting from credits, exemptions, and deductions.

The Chairman asked if all those industries should be subject to similar information reporting requirements. Mr. Kamikawa said that it should be on an aggregate basis if done. He pointed out that the confidentiality a credit affords is appropriate in some cases as opposed to a subsidy in which the recipient's name is not afforded the same confidentiality. As an example, he mentioned that it is for social policy considerations that the federal earned income tax credit affords confidentiality to low-income taxpayers who may then avoid the stigma associated with receiving a subsidy. Similarly, a credit rather than a subsidy is appropriate for the QHTB investment tax credit, because disclosing the name of the investor would work at cross-purposes to encouraging investment. Once public, anything could happen to that name; it could, for example, be in the headlines of the paper.

The Chairman said that it seemed that it was just the name of the investor that was of concern. Mr. Au disagreed, and said that he believes that the name of the company invested in should also be kept confidential. How well product development is going, how well capitalized they are, and other proprietary information is critical at every stage.

Ms. Chung stated that their main concern is that only aggregated data be released. The problem, as she sees it, is that the data already exists and that it is a matter of getting that data released by the Department. The problem with introducing legislation to modify the credit provision is that it introduces an uncertainty that may make investors reluctant to invest.

The Chairman noted that people have said that the State is scaring off investors with those headlines, but questioned whether it was the deal rather than the credit that leads someone to invest. Mr. Kamikawa believes that it is a concern; while he doesn't feel as strongly as Mr. Au about disclosing the names of the companies, he did receive calls in 2003 and 2004 when there was a spate of headlines from concerned persons who did not want the names of their companies identified as having investors who benefited from the QHTB investment tax credit. Unlike some, they were much more media-shy, and did not necessarily want to invite scrutiny by investing with a company that was featured in the press.

Mr. Au mentioned that, with respect to the digital media credit, the administration, including the film office of DBEDT and the Attorney General, believe that information regarding the investors and films should be confidential. He doesn't know where the administration stands on the QHTB investment tax credit, but it should be consistent with the film credit.

Mr. Roberts stated that the Commission has the opportunity to examine what was previously set up with good intentions and evaluate it by any standard they deem appropriate. As an accountant, he believes that what you measure is what performance you get. He surmised that many of the benchmarks that Mr. Kamikawa mentioned earlier were things that the public may have assumed they were getting, not as a byproduct, but as a primary benefit. His first question is whether they should be changing the measuring stick. Not whether there should be incentives for the high technology industry or not, but what should be done to get the credit. For example, should they provide information not just on the number of employees but how many were returning *kamaaina*. These kinds of data are not currently being collected. He mentioned that his CPA association regularly gets voluntary data from its members, information that is not generally shared, that are aggregated and put out on a timely basis. He's not sure whether it is fair to put such a burden on the State and then challenge them by saying that they should have talked to the industry on an individual level. He asked why it shouldn't be built right by doing this through the trade association.

Ms. Chung said that information about the credit is already with the Department. Her organization did try to do a survey looking at such things as returning *kamaaina*. She believes that they need to work together on this issue. The Department can collect some data while the trade organization collects subjective data such as the number of returning *kamaaina*, types of jobs being created, and how the companies and investors feel.

Mr. Roberts expressed his opinion that, since a number of years had passed, that the organization would have had such data already. Ms. Chung explained that they don't have good data about the industry as yet. The Department knows exactly how many QHTBs there are and exactly how many investors there are. The trade association doesn't know who all the QHTBs and investors are so it must begin with the Department and the Department can then turn over the data to the organization.

Mr. Kamikawa explained that, unlike the CPA organization that has access to those licensed as CPAs with the DCCA, the organization that Ms. Chung represents is a membership organization and it wouldn't know about everyone in the industry. However, Mr. Roberts countered that there were trade associations for all kinds of businesses, and they all have standardized data on a range of relevant items.

Mr. Au stated that the Tax Department is in a unique position to collect the data on the credits for two reasons. First, every investor has to report it to the Tax Department. Second, the Tax Department has stated that there are about 200 QHTBs and it can compel a response under penalty of perjury to a questionnaire whereas they would be under no obligation to respond and respond accurately to a trade association survey.

Mr. Roberts stated that he didn't want the next Tax Review Commission to be having the same kind of dialogue with the industry in which the industry is saying that the Department data are bad. He'd rather they just come forward with data it has collected. Ms. Chung stated that they did get a grant at the end of the last Legislative session to start putting a directory together.

The Chairman summarized by saying that they all agreed on the need for more data.

TESTIMONIES AND DISCUSSIONS

Dr. Patrick K. Sullivan. Ms. Chung introduced Dr. Patrick K. Sullivan, founder of Oceanit. Dr. Sullivan's written testimony is included in these minutes as Attachment 8.

Dr. Sullivan noted that what the QHTB investment credit had done, whether by accident or design, was to bring greater familiarity with technology companies by decreasing the investment risk. He does agree that more measurement is needed, but his experience is that the credit is working. He also mentioned a publication called *Venture Source* and a study done on Israel. More Hawaii money needs to be invested in Hawaii companies, and this credit helps that.

Mr. Roberts noted that he has seen in his practice technology companies leave Hawaii due to the lack of appropriately educated workers. In such cases, Hawaii taxpayers may be putting money into ventures that leave. He asked what needed to be done to keep companies like Dr. Sullivan's here. Dr. Sullivan stated that he'd start with getting the State to understand why this is important and to express it in the way they measure their progress. For example, movie deals and technology companies should not be considered the same. The technology industry is trying to put together a message that will get people even of school age to believe in the future of technology in Hawaii, but things manage to confuse that message. Although they try to recruit local people, he finds it hard to convince them to return to Hawaii to work.

The Chairman asked if any of the new people he spoke of hiring were University of Hawaii graduates. He said that the University of Hawaii does not produce enough engineering and science graduates. He emphasized that this starts before high school so that they don't get behind the curve and have a hard time catching up. His company therefore does educational outreach.

Dr. Grandy asked why investors are unable to see the benefit of technology investments. He asked if it was really a matter of perception or whether there were other investments that had a higher rate of return. From a tax structure perspective, a concern about tax credits is that it directs investment through legislation, and that is fundamentally contradictory to the notion of an entrepreneur. The concern in not with the productivity of technology companies, but whether too much is being invested because public decision makers don't have the kind of information that the industry does. Perhaps the public dollars should go to another economic sector such as agriculture or perhaps not to private industry at all. The concern, therefore, is the misallocation of resources. In response, Dr. Sullivan further discussed how the QHTB investment tax credit has helped investors see how they could make a lot of money investing in technology companies.

Dr. Robert Robinson of the Hawaii Angels and a University of Hawaii professor running the Entrepreneurship Center there added that, regarding messing with the free market, there are two issues. The first is the idea that the tax credits distort the market, and the second is that the State shouldn't be in the business of picking winners and losers. He disagreed with both. First, he believes that there isn't really a free market since the tax system has been built to support tourism, and prior to that agriculture. This credit is trying to redress that and reversing what Forbes has termed the most hostile environment for doing business in the country. Second, other states are spending billions in tech because they are highly productive and generate high-skill jobs, and this is the tech era. He feels that the State would be remiss if it didn't try to encourage the development of high-skill, high-wage jobs here to replace the low-skill, low-wage service jobs offered by tourism. The Chairman asked if Dr. Robinson was an economist; he was not.

Mr. David Watumull. Ms. Chung introduced Dr. Watamull, President and CEO of Cardax Pharmaceuticals and the former CEO of Hawaii Biotech as the next speaker.

Mr. Watumull stated that he wanted to provide the life sciences perspective. Hawaii Biotech spun off Cardax and also sold off another portion of Hawaii Biotech, PanThera Biopharma. Five years ago when he joined Hawaii Biotech, the company had about 12 employees; there are now 70-80 employees for the three companies combined.

Hawaii Biotech was able to raise $25 million over about four years of time much of which was stimulated by Act 221/215 investments. About 40% came from the mainland, and would not have been forthcoming had it not been for the local investments. Regarding measurements, he would like to see more measurement of this kind of thing and he would be willing to put this kind of information on his forms.

Nationally, venture capital funding for this type of company was difficult unless they were conducting mid- to late-stage human clinical trials. Venture capital funding for the life sciences was not the case in Hawaii due to the credit, and led to a significant amount of progress, taking the company from ideas to products that showed efficacy in animals. The early clinical human trials are likely to occur in Hawaii.

Mr. Watumull recently received a call from one of the largest venture capital firms in the country expressing interest in one of the companies. He believes that the venture capital company would not have called previously, and only did so now because of the progress that the earlier Act 221/215 supported investment had funded. However, future investors may want the company to move to the mainland, and the only way to keep the companies here is to have the capital here. The Act 221/215 credit provides an answer in addition to the 20% Hawaii research credit. Places like Silicon Valley, Massachusetts, etc., suck good companies from other locations simply because the money is there; Act 221/215 helps prevent the same from happening to Hawaii companies.

Mr. Watumull also believes that the QHTB investment tax credit reduces the risk for the investor, but also for the company because it makes the company a more attractive investment if investors know that there are local investors willing to match their investment.

Regarding jobs, Mr. Watumull stated that life sciences companies have an initial period of five to eight years during which there must be significant capital contributions, not just one or two years, because there are no revenues. However, within two to three years of becoming successful (i.e., making a major transaction with a major pharmaceutical company and getting FDA approval) the increase in jobs can be and has been dramatic. In other companies, employment has grown from a hundred to thousands. Therefore, people must be patient with job growth numbers in the life sciences area.

Mr. Roberts expressed concern with matching the resources of the State with the scalability of the company. He asked where the people would come from if 5,000 jobs are created. His fear is that Hawaii is providing the seed money for California's or Singapore's next success story. Mr. Watumull acknowledged that as a concern, and that it must be addressed with sufficient capital and he believes that it can be done; both the ability to create the jobs and recruit the people needed for those jobs are real. He cited San Diego as an example of a city that went from tourism-defense-agriculture to high technology, and said that people are moving there as a result. He receives e-mails from people who want to work for him, but he cannot hire them all.

Mr. Patrick Sullivan added that it also is personal, because they prefer to be here. He acknowledged that some companies may leave, but believed that others would decide to stay by not taking an investment that would require them to leave. Doing so may put the company at risk, but it is a personal preference. That kind of will to remain won't happen unless you have at the company people who live here and have family here. This is why it is important to build companies from the ground up, which is what Act 221/215 allows.

<u>Dr. Robert Robinson</u>. Ms. Chung introduced Dr. Robinson, founder of UH Angels, now known as Hawaii Angels, as the next speaker. Dr. Robinson's presentation slides are included in these minutes as Attachment 9.

Dr. Robinson stated that he didn’t know about Act 221 before he moved here in 2001 and took over entrepreneurship program at the University of Hawaii; he just has as a priority an angel investor network, which he thought the State needed to generate seed financing. As it turned out, the credit afforded him an opportunity to educate investors and get them to try it.

They focus on the type of companies that the Act envisioned, not tax schemes. Not all 34 of the technology companies they invested in are QHTBs. They are for the most part 1:1 investors. A few investors are interested in 2:1 deals though they would then need other investors.

One of the companies listed on slide 1, Napo Pharma, is not a Hawaii company, but was referred by a venture capitalist who regularly visits Hawaii. Dr. Robinson mentioned it because mainland companies are increasingly contacting the Hawaii Angels to see if they can work the credits. Sometimes they say "yes," and sometimes "no." Some companies have relocated here specifically for the QHTB investment tax credits. He thinks that attracting mainland entrepreneurs to Hawaii was also part of the vision for this credit.

In view of the 6-2-2 rule that Mr. Au had mentioned, it is remarkable that all the companies they invested in are still operational, although two or three have moved to the mainland.

Dr. Robinson stated that what is now needed is next-stage investment, and that involves a partnership with mainland investors and the State addressing that aspect of capital formation. He is concerned about poor reasoning on the part of those questioning the credit whether in the paper, the legislature, or the street without proper measurement criteria. As an academic, he wants to see data, but the constant arguing about it has a corrosive effect. The credit is for a certain period of time and should be allowed to run its course; data should be collected and conclusions then drawn. Instead, what is happening now is interfering with the ability of the Act to operate as it should.

He believes that the critics of the companies being invested in are wrong. They have gone through a series of criticisms that have been proved incorrect and now are positing that the gains are ill-begotten.

His stated preference is to have an independent body, perhaps a partnership between industry, academia, and government, collect the data and commissioned to conduct a study with data released in aggregate form. He doesn't believe legislation is required for the Department to release aggregate data.

Mr. Roberts stated that there is no data on the number of drop-down and related-party entities structured to obtain credits, and that could poison what is otherwise a good thing. He asked if Dr. Robinson had any recommendations for addressing this issue while still retaining confidentiality. Dr. Robinson shared his concern and stated that he did not support them, but he did not have any recommendations on how to address the issue. Mr. Au stated that he believed that the issue was addressed in Tax Information Release No. 2003-01, that the problem has gone away, and that the Department should be able to provide data, in aggregate form, on the number of inappropriate drop-downs there are in violation of the Tax Information Release.

Dr. Grandy expressed concern with the statement that a number of companies could not have started without the credit, and asked if Dr. Robinson was concerned that regular economic conditions were insufficient. Dr. Robinson said that the companies that they invest in must meet the same economic standards as companies for whom the credit would not apply. He distinguished between the quality of the company and the experience and sophistication of the investor base in Hawaii, which has not traditionally invested in private equity deals. Hawaii Angels does not invest in companies that they don't expect a 10x return on.

Dr. Grandy asked if it was unfair to characterize the wedge that has been placed between the financial risk that the investor faces after the benefits of Act 221/215 and the actual risk of the company as additional risk being borne by the taxpayers. Dr. Robinson acknowledged his position, but said that the issue is one of framing the issue, which he prefers to see the credit as the State making an investment in trying to encourage people of means to consider alternative asset classes for their investment. Every incentive offered by the State is the shouldering of risk on behalf of some entity or group in order to accomplish a certain aim.

Regarding the "chilling effect" mentioned, Dr. Grandy said that he presumed that it was not intended to mean that nothing should be said and the credit allowed to run its course simply because the legislature passed the legislation. Dr. Robinson believes that it is appropriate for the Commission to monitor the credit to ensure that the public trust had not been violated. The problem is that it is being done with very imperfect information that is being cherry picked by those with agendas making it a political rather than an objective process. The criteria need to be established, and some sort of timeline or target should have been established beforehand against which the data could be measured. He noted that the only down year his organization had was in 2003 due to the negative press reports.

Ms. Chung added that, on many occasions, inaccurate and wrong data are released. For example, she stated that the $1 billion dollar figure reported yesterday was wrong. However, Dr. Grandy asked how she could assert that the $1 billion dollar figure was wrong. Ms. Chung stated that she was told that the $1 billion dollar figure was a preliminary figure, and that the final number that came out of the Council meeting was less than that. Mr. Au added that Director Kawafuchi issued an e-mail the previous evening that stated that the number was inappropriately disclosed, and that it doesn't reflect the Department's position. However, Dr. Grandy stated that the Director's e-mail doesn't mean that the number is wrong, to which Mr. Au said that at it at least did not reflect the Department's views as stated by Director Kawafuchi.

Dr. Grandy stated that this is related to his last question. Everyone agrees that better data are needed, so it was premature to say that the data clearly support one side or the other.
Dr. Robinson said that he believes that the data on the companies' side, as opposed to the state policy side, clearly show that the critics are wrong although there is not enough data to show that he is correct. He notes that the "end game" for him is when the company goes public and that what happens after the initial public offering (IPO) is beyond what the Act envisioned. He was willing to wait for five years before saying anything if the other side was willing to do the same. However, if the opposition continues throwing out "half-baked" accusations that are inappropriate or wrong, then they must respond with the information at hand.

Mr. Heller noted that Dr. Robinson had said that Hawaii is not perceived as a good place to do business. Hawaii has issues with its overall rate of taxation, regulatory climate, labor laws, etc., although the extent to which it is perception or reality can be argued. He asked about the extent to which Hawaii can build a strong, healthy, vibrant, high-technology industry without addressing the underlying problems that affect businesses in general. In addition, how should the Legislature prioritize a high-technology credit and building up the high-technology industry versus attacking the larger problems?

Dr. Robinson did not think he was qualified to answer Mr. Heller's second question. However, there is a virtuous cycle emerging in which the leaders in high-technology such as Dustin Shindo and David Watumull get a bigger seat at the table to influence the views of legislators on matters just as the tourism industry did before. There is such a thing as bootstrapping and that is what is happening now. He doesn't think that Hawaii will ever be a Silicon Valley, though San Diego may be a better role model, and if they select appropriate areas such as marine sciences, agriculture, alternative energy, and certain life sciences, the credit will allow Hawaii to market itself to mainland investors and entrepreneurs who had previously dismissed Hawaii as a tourism destination.

Mr. Watumull added that, with respect to the life sciences sector, where companies can get capital is what drives them rather than low taxes. Therefore, while the regulatory climate and such are of concern, those factors are not what build a technology industry.

Ms. Jennifer Nakanishi. Ms. Chung introduced Ms. Jennifer Nakanishi who spoke on behalf of Mr. Dustin Shindo, Chairman and CEO of Hoku Scientific, who was unable to attend. Mr. Shindo's written testimony is included in these minutes as Attachment 10.

Ms. Nakanishi stated that she had been with Hoku Scientific for three years and was their eighth employee. When they began at the Manoa Innovation Center, they occupied a space smaller than the meeting room and they now occupy 22 thousand square feet in Kapolei. She is not a technology person; she is Mr. Shindo's assistant and the human resources person who recruits new employees. A few years ago, people at job fairs would just pass them by. She now has lines of 20 people wanting to work for them, and is excited to be able to provide that kind of opportunity to local people. Mr. Shindo and his co-founder, Mr. Karl Taft, were born and raised in Hilo, had good jobs on the mainland, but returned to start Hoku Scientific. About 2/3 of their employees are either from Hawaii or have ties to Hawaii. Act 221/215 afforded the company many opportunities as a small start-up that they would not have otherwise had.

Mr. Bill Spencer. Mr. Bill Spencer, President of the Hawaii Venture Capital Association, was the next speaker. His written testimony and presentation slides are included in these minutes as Attachment 11 and Attachment 12, respectively.

He believes that the Department has all the numbers necessary, as he got some numbers from the Department through a Freedom of Information Act request in 2003, but it took some effort for them to do it, and when he tried to get the same data in 2004, he was unable to get it. He recognized the Department's competing priorities.

He intended to give a historical perspective from his point of view as an entrepreneur (founding or leading six businesses in Hawaii since 1991). In 1985 when he first came to Hawaii after Mr. George Mason told him that he should relocate his software company here, there were five technology companies, motivated by Governor Ariyoshi's idea that technology would be a clean industry that would capitalize on Hawaii's strengths and unique competitive advantages. When he finally did come five years later and asked about venture capital, he had appointments with the by then retired Governor Ariyoshi and the Magoon family (Hawaiian Airlines).

In 1993, the Hawaii Strategic Development Corporation was established to attract venture capital. Mr. Spencer went to see Mr. Billy Richardson's company, HMS Hawaii, but was told that they didn't invest in software companies. In 1995, he joined the board of the Hawaii Venture Capital Association and began counseling what became hundreds of companies all suffering from a lack of venture capital. In 1997, he went back to HMS Hawaii, which was still one of the only venture capital firms in Hawaii, with an idea for an Internet-based Hawaiian radio station, but was told that they didn't invest in Internet companies.

At the same time, the Hawaii State Employees Retirement System (ERS) was authorized to use 3% of its corpus, about $300 million, for alternative investments. Half went to mainland top-tier venture capital firms, and the other half went to forestry projects on the mainland. At that time, he was told that the ERS as a matter of policy, unlike other retirement systems, wasn't willing to do targeted investment.

By 2001, the IRS reported that Hawaii individuals and families had a net worth of $90 billion. Mainland investment firms managed most of that money. When Mr. Spencer asked some of his friends why, he was told that they didn't want local people to know how they had invested their money.

Act 221, SLH 2001, was envisioned as a way to get that money away from the mainland and back into the economy. Mr. Spencer then went over his slides.

His concern was that additional rounds of funding are needed for continued growth but the constant need to re-evaluate the program was premature and the companies have not matured. He noted that almost 80% of that money is invested in life sciences, software, and information technology type companies with the balance going into retail and a new category called "green" companies.

Mr. Spencer then went over some of the impacts on Hawaii that would be difficult to quantify. He suggested as a good reference the Hawaii Institute of Policy Analysis book on other indicators for measuring the industry.

<u>Mr. Jeffrey Au</u>. Ms. Chung introduced the final speaker, Mr. Jeffrey Au of PacifiCap. His written testimony and a copy of an e-mail sent to Dr. Bruce Bird following the October 6, 2006, meeting, both of which were distributed at the meeting, are included in these minutes as Attachment 13 and Attachment 14, respectively; his presentation slides were not provided.

He began is comments by stating that an article in the previous day's *Honolulu Advertiser* about venture capital stated that $6.4 billion was invested on the mainland in the last quarter alone, which provided some idea of the amount of money needed for this industry. Compared to that, even the $1 billion over ten years figure previously mentioned is not much.

PacifiCap has invested in more than 16 companies, 90% of which have operations in Hawaii, and 90% of which also have operations on the mainland and Asia as well. They have raised a total of $360 million since 2000, which includes both Act 221 and non-Act 221 investments. PacifiCap's investor base consists of a nice mix of more than 60 institutional, company, family, and individual investors. They have invested more than $25 million in Act 221 investments to date. His company's role is to find good investments and to get the credits the investors expect as a condition for using their money.

The company takes an institutional approach to investing, and is interested in international transactions cross-border with Asia, interdisciplinary in integrating the financial, operational, legal, and tax expertise together with industry knowledge and local roots.

Mr. Au did not grow up wanting to make tax deals. His focus while doing his masters at Stanford was economic development in less developed countries, particularly on why Asia succeeded and Latin America failed, and why traditional models of comparative advantages of efficiency and pure market forces led to boom-bust economies and banana republics that increased income inequality in less developed countries and why Asia succeeded because of hybrid models of government incentives combined with market forces. It was theoretical then, but he believes that there is enough history now to show why that is so.

He then mentioned other members of the team including experts in wireless telecommunications, life science, digital media, and China. He was concerned that some people believe that all PacifiCap does is tax scam deals, but that the expertise of the team reflects otherwise.

Act 221 has greatly helped the deal flow. He was supposed to be the partner on the mainland, but with 90% of the deal flow occurring in Hawaii, he is here. It has reduced the risk of the company running out of money before the products are ready to go to market. The bottom line is that high technology in Hawaii is no longer a joke.

Regarding the availability of data, Mr. Au believes that the data is available but the bottleneck is the release of that data by the Department of Taxation. Director Kawafuchi just a few weeks previously stated that the 2004 and 2005 data was unavailable, but that information was on the front page of the newspaper the previous day. He asserted that it took three years to get data released for 2003, three weeks to get data released for 2004, and three days to get data released for 2005 (he pointed out that the extended due date for filing 2005 tax returns was October 20, 2006), and 2010 data four years in advance. What needs to be examined is the process for collecting and releasing the data.

For the record, Mr. Au stated that he personally believes that the professional staff, including Director Kawafuchi, is professional and conscientious. The question that should be asked is whether the release of data is a function of politics. He would like to know what role other departments have played in interfering with the release of data, whether DBEDT, the Governor's Policy Office, or the Governor's Press Office.

His written testimony doesn't dispute the data, but it shows the contradictions and huge discrepancies between the data that was released, including the data released the previous day, such as discrepancies between DBEDT and Tax Department jobs data.

He made additional comments regarding the need for confidentiality, and the need to rely on primary source data and keep other departments that do not have authorization to access tax data out of it.

At the conclusion of Mr. Au's presentation, the Chairman asked if there anyone else wanted to say something. None did. Mr. Roberts asked if there was anyone from the performing arts industry or anyone who wanted to address whether the inclusion of performing arts in Act 221 was appropriate or not. There was no response, but Mr. Blanchette asked why that question couldn't be addressed anyway. Ms. Chung noted that, at the time, Square USA was doing business in Hawaii and doing digital work for the film industry. She believes that it was the intent to target that type of company rather than the motion picture industry, and that the film industry has been addressed. Mr. Au believes that it is different from technology companies they've worked with, but they are starting to look at some such companies involving computer animation and the like. He cited programs at Waianae High School and the University of Hawaii.

Ms. Chung mentioned that it was unfortunate that Mr. Hank Rogers had been unable to attend because he is off-island, because he had just sold his company, which developed Tetris for cell phones, and had on other occasions said that Act 221 was the reason he brought his company to Hawaii.

Mr. Spencer added that one intention of the Act was to incorporate digital media and post-production for the film industry and also Hawaiian music, which has a global reach.

Dr. Grandy asked if Mr. Au had data to support his contention that the Act increased the deal flow. Mr. Au has some numbers but that they are not updated. His company invests in five to 10 percent of the deals they look at. He believes that the numbers are increasing and that the companies are also improving qualitatively. They could try to put some numbers together, but he conceded that at least some of it is anecdotal and qualitative.

Mr. Robinson noted that he has changed his position somewhat on movies. His group has not invested in movies, but they have invested in the television series, *Beyond the Break*, which just got picked up for a third season and does all of their production and post-production here.

<u>Other</u>. Included with these minutes are written testimony submitted to the Commission from Mr. Henry Ting, President of NBT 168 Technik, LLC (Attachment 15), Ms. Jeanne Unemori Skog, President and CEO of the Maui Economic Development Board, Inc. (Attachment 16), Mr. David Fisher, Maui Center Director of the Hawaii Small Business Development Center Network (Attachment 17), and Mr. Scott Weeker, President and CEO of Ambient Micro (Attachment 18).

ADJOURNMENT

The Chairman thanked the industry representatives and all present for their attendance and participation. Ms. Chung also thanked the Commission for the opportunity that they were given.

<u>It was moved by Mr. Heller and seconded by Ms. Ching to adjourn the meeting at 11:50 a.m. The motion was carried unanimously</u>.