TAX REVIEW COMMISSION

MINUTES OF THE NINETEENTH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT STATE CAPITOL, ROOM 211
IN THE CITY AND COUNTY OF HONOLULU
STATE OF HAWAII, ON FRIDAY, OCTOBER 6, 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 Friday, October 6, 2006.

Members Present: Chairman Isaac Choy, Manoa Consulting Group, LLC CPA's
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

Members Absent: Vice-Chairman Ronald Heller, Torkildson Katz Fonseca Moore & Hetherington, AAL, ALC

Staff: Tu Duc Pham, Donald Rousslang, Cathleen Tokishi

Other: Marcia Sakai, University of Hawaii – Hilo
Bruce Bird, University of West Georgia
Jeffrey Au, PacifiCap Group
Stanley Baptista, DOTAX
Stephanie Beran, DOTAX
Uddhav Bhandari, DOTAX
Harry Blanchette, Senate Minority Research Office
Hayley Callahan, DOTAX
Carrie Carlin, Stryker Weiner & Yokota Public Relations, Inc.
Ann Chung, Hawaii Science & Technology Council
Diane Erickson, Dept. of the Attorney General
Jay Fidell, Think Tech Hawaii
Peter Fritz
Lisa Gibson, Hawaii Science & Technology Council
Craig Hirai, Bowen Hunsaker Hirai
Sean Hao, Honolulu Advertiser
Lori Hiraoka, Goodsill Anderson Quinn & Stifel
Walter Ida, Territorial Savings Bank
Pearl Imada Iboshi, DBEDT
Nandana Kalupahana, House Finance
Ray Kamikawa, Chun Kerr Dodd Beaman & Wong

Martin Kao, Accuity LLP
Kurt Kawafuchi, DOTAX
Ian Kitajima, Oceanit
Larry Lieberman, Referentia Systems
Theodore Liu, DBEDT
Johnell Nakamura, DOTAX
Marilyn Niwao, Niwao & Roberts, CPAs
Cathy Owen, Nanopoint, Inc.
Manu Ritchie, Enterprise Honolulu
Bill Spencer, Hawaii Venture Capital Association
Nicki Thompson, Governor's Policy Office
Joseph Tichy, DOTAX
David Watumull, Cardax Pharmaceuticals
Betty Wong, DOTAX
Stewart Yerton, Honolulu Star-Bulletin

CALL TO ORDER

Chairman Isaac Choy called the meeting to order at 1:43 p.m. with a quorum present.

ANNOUNCEMENTS

Introduction of Dr. Marcia Sakai. The Chairman introduced Dr. Sakai, the founding Dean of the College of Business and Economics, University of Hawaii at Hilo, and Professor in Tourism and Economics. She served as a Commissioner for the 1995-1997 Hawaii State Tax Review Commission, policy analyst for the State Department of Taxation, economist for the State Public Utilities Commission and consultant to the Office of State Planning and private corporations. She holds Ph.D. and M.A. degrees in economics and B. A. and M.A. degrees in mathematics from the University of Hawaii.

Introduction of Dr. Bruce Bird. The Chairman also introduced Dr. Bird, a Professor of Accounting in the Department of Accounting and Finance, Richards College of Business, at the University of West Georgia. He teaches both undergraduate and graduate courses in the areas of accounting and taxation. Dr. Bird received his B.A. in Economics from Vanderbilt University, and his J.D. and M.S. (in Taxation) from the University of Cincinnati College of Law. He is both an attorney and CPA in the State of Tennessee.

<u>Questions for the Presenters</u>. The Chairman informed the attendees that, following the presentation by Dr. Sakai and Dr. Bird, the Commissioners would first have the opportunity to ask questions and then the public. He also asked that the members of the public ask questions and refrain from making long speeches in the interest of moving the meeting along.

PROFESSOR SAKAI'S SEMINAR PRESENTION

Dr. Sakai and Dr. Bird distributed to the Commission copies of a PowerPoint presentation on their study, "Measuring the Costs and Benefits of Hawaii's Qualified High Technology Business (QHTB) Investment Tax Credit Under Act 221 and Act 215."

Dr. Sakai thanked the Commission for allowing them to study one of the most interesting of the credits on the list of credits the Commission wanted studied. She said that their presentation would begin with Dr. Bird's review of the statutory provisions and comparison with other locations, continue with Dr. Sakai's cost-benefit economic analysis, and end with some comments and preliminary recommendations.

Dr. Bird covered the first part of their presentation slides. Dr. Sakai then presented the slides covering the cost-benefit data and analysis. Dr. Bird then presented the slides on job creation. The slides are attached to these minutes; the details of this part of their presentation are contained in their draft report.

Dr. Sakai and Dr. Bird then listed preliminary recommendations not contained in their slide presentation and draft report. Dr. Sakai first stated that the purpose of their study was NOT to say whether this credit is the best thing since sliced bread or that it is the worst thing that the State ever did. Rather it was to look at available data and share with the Commission their findings based on the data.

1. The credit has been successful in raising significant amounts of capital for QHTBs, but this is an intermediate outcome. Because of the public subsidy that is involved, the study should look beyond the level of investments received. Therefore, they recommend that this, as with any other tax credit program, be treated as a tax expenditure – as money that is not otherwise going into the treasury for public purposes – and bear the same burden of proof that any program involving direct expenditures would be required to provide. There also are ground rules that have been recommended by scholars and practitioners in the area for assessing the cost effectiveness of the credit and to have some level of transparency and accountability. The ground rules are in the report.

2. The Department of Taxation should collect and make public more extensive and timely taxpayer data relating to this credit. It could be that the internal processes are such that the information on the Forms N-317, N-318, and N-318A are not collected on as timely a basis as might be helpful. Act 215 says data is to be collected but doesn’t say when. The law infers that the data should be collected on a timely basis, but it isn’t. Dr. Bird noted that they had access to

preliminary 2003 data and didn't have access to 2004 and 2005 data. They realize that there is a lag for the 2005 data, but the 2003 and 2004 data should be available. He understood the confidentiality concerns, but he believed that the data could be tracked without using the taxpayer's social security number (SSN) or employer's identification number (EIN) and the data released without the taxpayer being identified. He noted the problem in 2004 when the Department tried to get employment data from the State Department of Labor and Industrial Relations, but felt that legislation should be pursued if necessary. Dr. Bird reiterated that the law does not require that jobs be created.

3. Make sure that Form N-317 is filed for each year. What instructions there are don't say that annual filing is required, and implies that it need not be filed unless a cash investment is received. The Form N-317 itself is confusing and could be improved. Data collection is difficult when narratives are required.

4. This kind of credit requires a lot of administrative resources for collecting information, auditing, and also litigation.

QUESTIONS AND DISCUSSIONS

Mr. Roberts commented that they had initially hoped only for a shopping list of what was needed for the next time and that he was impressed with what they did. He also noted that his high tech clients had left Hawaii because there were not enough PhDs to take it to the next level rather than credit considerations. He then asked if they felt that this credit was more of a tax planning tool or incentive than something having real economic substance.

Dr. Sakai stated that the real question was, when you look at the totality of the credit, would it benefit the state to that extent.

Mr. Roberts then asked if the Commission was measuring the wrong thing if the goal was to increase high paying jobs for Hawaii's youth.

Dr. Sakai agreed that alternate measures should be considered, keeping in mind that it must be a longer-term effort because startups do not expand and hire many people in the initial years. Regular, if not annual, evaluation of the performance of these companies should be conducted and would help determine how effective the program is over time.

Dr. Grandy stated that the study indicated that the credit did generate significant investments in QHTBs, yet comparing Hawaii's share of venture capital with the national share, the increase over time has been less than the national share, which seemed odd given the unique or unusually generous nature of the credit. He asked if they felt that this was an anomaly for that one-year period, if it would continue, or whether they also felt that it was odd.

Dr. Sakai stated that her comment regarding its success was in absolute rather than relative terms. In dollar terms, this could be the biggest or nearly the biggest tax credit program that the

State has ever supported. One person she interviewed said that Hawaii venture capital companies are not interviewed for this national survey. She noted that the National Science Foundation data footnote said that, due to a lack of data, they had to do estimates, adding that Hawaii is not the only state for which this was true.

Dr. Bird reiterated that their slide reflected investments by private institutional venture capital investors, and that is where most capital is raised. One inference is that, despite the credit, not enough companies are making it to the next level where private institutional investors would get involved. He mentioned a Honolulu Advertiser article in which Barry Weinman, Managing Director and Co-founder of Allegis Capital, suggested that pension funds, endowments and trusts do not consider tax credits when evaluating investments. There is a possibility that companies utilize the credit, get to a certain level, and then leave because they need more employees with certain skill sets, but it could mean that they may need to go elsewhere to seek more venture capital. That is a national phenomenon, and Dr. Bird noted that an article in the previous day's Wall Street Journal indicated that more high tech companies that start in Connecticut and other areas are moving to Silicon Valley because its environment facilitates the raising of venture capital.

Dr. Grandy noted that most of the 19 states they listed as having tax credits have per capita income lower than median. The states could be looking for ways to augment income, but if they are actually raising these companies with tax credits and then sending them abroad, perhaps that could also be generating some of the reduced performance.

Dr. Grandy observed that their draft study noted that 33 of the 78 QHTBs did not file general excise tax (GET) returns. Dr. Sakai replied that the Department of Taxation had provided several tables with information on QHTBs of various kinds for 2003. From that, she determined that there were 78 QHTBs that did some kind of reporting, and that 33 of the 78 did not file a GET return. It is likely that they had no income but that would be the most positive interpretation as it would seem unlikely that such a company would not file out of ignorance, and it could be reasonable since many QHTBs have no revenue initially. However, Ms. Ching noted that the filing of GET returns was required even if the company had no income, such that it didn’t seem reasonable to assume that the company had no income. Dr. Sakai said that she could not make a determination because the column just said "no info".

Dr. Grandy stated that confidentiality was important, but that transparency and accountability were crucial issues. It would be useful to include in the final report positive recommendations on how to resolve the conflict between the need for confidentiality and the need to evaluate the credit. As a tax expenditure, the State should be able to determine its efficacy. It may be possible for the Legislature to authorize other departments to cooperate with the Department of Taxation in a way that assures confidentiality but still allows the collection and analysis of data. It may be that the data could be constructed in such a way that would make it better for an outside agency to do the analysis. He would like them to wrestle with that and be creative in coming up with recommendations.

Dr. Bird stated there were ways that it could be done, citing the intake sheets used at their tax clinic from which they redact identifying information in order to satisfy the demands of their grant. It shouldn't be that hard to do, although the Legislature may need to mandate the provision of this information.

Dr. Grandy noted that he had heard that redaction may be insufficient when there are a small number of taxpayers because people could identify the company based on the information provided.

Dr. Bird stated that, if the company was generating information for the Department anyway, then perhaps it could be generated in such a way, via the Internet for example, that only certain fields would carry over and if there were only a few, then they could be consolidated with another category at the Department level and they would have access to timely data.

Dr. Sakai added that, if the data was entered electronically via a secure website, then the issue of timely data would go away.

Dr. Grandy asked if they had presumed that all QHTBs survived until 2007 for purposes of their cost-benefit tables. Dr. Sakai confirmed that presumption. While some won't survive, the survivors would probably have a large revenue stream. She could not predict how much the survivors would offset the nonsurvivors.

Dr. Grandy asked if Dr. Sakai had considered using survival rates from other industries. Dr. Sakai stated that the five- to seven-year survival rate estimate for this sector of venture capital investment was that 20% of the companies would survive and 80% would not. However, the 20% would be so scalable, so big, that from a portfolio perspective the portfolio would earn a fairly good rate of return.

Dr. Grandy asked if, in doing their comparative research, they had come across in information that suggested that Hawaii had developed a reputation, good or bad, as a result of this credit. Dr. Bird answered that he doesn't comment on reputations, but that he could provide a quote from the Community Development Venture Capital Alliance, which in July 2004 put together a state tax credit incentives for equity investments survey of current practices. They wrote the following in a part discussing the tracking of program effectiveness, which Dr. Bird noted a number of states have a problem with:

> "The Hawaii Department of Business, Economic Development and Tourism reported significant benefits from Act 221, its tax credit program. The creation of 600 technology jobs at an average salary of $46,000 dollars, a wage very close to the $50,000 living wage required to fundamentally change the state's economy. However, as previously discussed, Hawaii is currently auditing nearly one-third of all of its tax credit claims over the past two years."

Director Kawafuchi stated that the Department audits about 1% of all research credit claims. He didn't know what the percentage was for investment tax credit claims, but that he'd be surprised if it was one-third. Dr. Bird stated that an earlier article stated that up to 20% were being audited. Director Kawafuchi said that the article was old information and wasn't actually the number audited anyway. Dr. Bird said that he had asked for the audit information and hadn't received that information. Director Kawafuchi responded that nobody had asked him. Dr. Bird asked Director Kawafuchi for the percentage of the dollar amount claimed that was being audited, noting that it could be 1% but be for a very large dollar claim, but Director Kawafuchi did not know. The Chairman said that it was unfair to put Director Kawafuchi on the spot and suggested that he ask Dr. Pham for that information before submitting their final report, a suggestion to which Director Kawafuchi concurred. Dr. Bird said that he had e-mails asking for that information, but that they were not given the answer. Director Kawafuchi stated that he would be happy to provide that information.

With respect to enforcement and the Department's need for more resources, Mr. Okada asked if that was due to the vagueness of the law, abuse, or something else they could point to. Dr. Bird stated that his hearing for the first time that only 1% of the claims were being audited may have an effect on his answer.

On the one hand, one wants a credit set up in such a way that those taking it can understand and apply it. On the other hand one doesn’t want to open it up to so much interpretation that people are pushing the envelope. He observed that the law is written such that it would take a lot of work to develop a case should a claim be audited.

Dr. Bird also noted that the response to their requests for information led him to infer that there was a problem with assembling the data. For example, they asked via e-mail for the number of comfort letter ruling requests asked for, but were told that the information was not available. He had an article regarding the number of comfort letter requests, and he assumed that more administrative resources would be needed to handle the increasing number of comfort letter ruling requests as the credit became more popular. This information was important because individuals seeking these rulings are often trying to structure deals involving investors, and they were trying to determine if there were any QHTBs that had very few members in them, and that information was not provided.

Ms. King asked if the ability to allocate the credit among investors disproportionately had resulted in more out-of-state investment coming into Hawaii or if the same money was churning within the state. Dr. Bird stated that he would like to have data in order to track it. He would assume that it could happen, but the extent to which it could exist was not contained in the data that they received. The reason is that this information is not on the Form N-317.

There were no further questions from the Commission members, and Mr. Roberts stated that he would like to hear from the industry and the Department of Taxation. The Chairman opened the questioning to the public attendees, but suggested that there by no "he said, she said" discussion.

Mr. Kamikawa began by stating that he believed that the industry could address the assumptions and data questions raised by Dr. Sakai and Dr. Bird. He suggested that it would be helpful if the panel and Chair could reserve a day in two weeks for the same amount of time. The Chairman expressed his willingness to do so, and asked if the Commission could receive the industry's materials in writing first. Mr. Kamikawa stated that two weeks is a relatively short period of time, but felt that they could put together an outline.

Director Kawafuchi agreed with Mr. Kamikawa. He added that he heard about a number of things for the first time, such as the number of comfort letter rulings not being made available although that is a number that the Department gives out, and he hadn't been approached about the audit questions; he would welcome the opportunity to give his perspective.

The Chairman noted, however, that it appeared that the Department's information was current for 2002, preliminary for 2003, and unavailable for 2004 and 2005. It would be unacceptable for a client of his to only have financial data for 2002. It would be great if the Director had up to date data available, because the lack of data is of concern.

Ms. Chung stated that the industry would like to speak directly with Dr. Sakai and Dr. Bird, and answer any questions that they may have. Although they apparently did speak to some people, they may not have spoken to some of the key people and companies benefiting from the credit.

Mr. Blanchett stated that he would like the public to be represented at the next meeting as well, to which the Chairman agreed. He stated that he had heard about the cost, benefits, and analysis of this targeted program, and asked if anyone had any information on the benefits of reducing the corporate and individual income tax in increasing jobs and tax revenue versus a focused program such as this. Dr. Sakai stated that she didn't think that they could answer that question.

Mr. Kao stated that it was important to meet with the industry. He cited as an example the inconsistency in the numbers on job growth between specific categories and aggregate data that indicated a decline in technology jobs. He noted that the research and development category showed real strength in job growth, and that is one of the key areas that qualifies a company as a QHTB. The Chairman asked if this would be part of his presentation at the next meeting, and Mr. Kao affirmed that.

Mr. Melendez stated that much had been said about how little data was available and questioned how much understanding of the industries went into the assumptions made in this study, and that it would be hard for them to point out incorrect assumptions if they don't know what those assumptions were. In the performing arts, for example, a lot of the investments were made by mainland investors and a lot of the credits were not claimed. Average wages may seem low on an annual basis, but most of the jobs were union jobs, and the low number is explained if one understands that the film companies come in for only two to three months.

Mr. Au of PacifiCap stated that the $2.9 million Hawaii investment figure given is less than what his firm invested alone. He suggested that they not use secondary data sources because they often were conducted by mainland research firms that don't survey Hawaii firms. He also suggested that they not rely on press reports because they contain inaccuracies that were perhaps due to inaccurate information provided to reporters.

The Chairman noted that this study was commissioned before the summer and was made public. He knows that the researchers had been struggling ever since to get data. To the extent they don't have data is not their fault, and is glad that the industry is coming forth.

Mr. Spencer referred to an early slide describing Dr. Sandler's categories of equity capital, love capital, angel capital, and venture capital. He stated that this got a little muddled with Dr. Grandy's question in which investment tax credit investment dollars were lumped into the venture capital category, which Dr. Sandler said came primarily from institutional investors that put the money into a private partnership which then invested in companies. For investment tax credit purposes, investments were also being made directly by high net worth individuals, angel investors, and others. He thinks that it is important to correctly distinguish between the different types of capital being invested.

Ms. Chung noted that there was ongoing discussion on the proper classification of technology jobs, and that could affect their job creation numbers. She then asked why only one credit was being studied when the original request was to study multiple credits. The Chairman stated that it was a function of the budget.

Dr. Bird stated that he'd love to talk with them, get information from them, and share with them the sources of the information he has. He stated that Mr. Au's comments could be valid and that Mr. Spencer's comment was well taken, although the point he was trying to make was that it didn't seem that many companies had gotten to that stage.

Dr. Bird noted that there appeared to be a lot of information that the people in the room had that could justify the credit if they were willing to share it with the researchers and get it on record. He suggested, as an example, that they ask the companies they have invested in to provide them with jobs numbers that they could aggregate. It would be in the industry's interest to encourage transparency.

Mr. Au stated that the jobs number is reported on the Form N-317. However, Dr. Bird stated that the information is confidential, but if companies would be willing to identify themselves to the researchers and tell them the number of jobs created, then that would be useful information. Mr. Au said that some of the companies and investors are concerned about an environment in which they are damned if the do and damned if they don't. For example, a high level of investment could be a good thing, but press reports speak of high levels of investment by insurance companies as if it were a bad thing. The companies are also very busy doing their research and can't afford to hire public relations firms.

Mr. Roberts stated that, when the Chairman speaks of the report, he means the Commission's report rather than the study report. Offering the industry a chance to present their information is simply to offer the Commission additional information for the Commissioners' consideration.

ADJOURNMENT

The Chairman thanked everyone for their attendance and participation, and directed Ms. Tokishi to work with the industry representatives to coordinate a meeting with the Commission.

The meeting was adjourned at 4:35 p.m.

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Measuring the Costs and Benefits of Hawaii's Qualified High Technology Business (QHTB) Investment Tax Credit under Act 221 and Act 215

Introduction

- Act 221—now Act 215 – provides eligible taxpayers a nonrefundable tax credit of up to $2,000,000.

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Introduction (cont'd)

- Act 221/215 applies to taxpayers subject to Hawaii's income, franchise, and/or gross premium tax who invest in a qualified high technology business (QHTB).

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Literature Review

- Fox and Luna (2002)
- Cornia, Edminston (and others) (2005)
- Multistate Tax Commission (MTC) (2003)
- Council of State Taxation (2003)
- Petroni and Shakleford (1999)

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“Business Climate” Studies

- Development Report Card (2006)
- Milken Institute State Technology and Science Index (2002)
- Milken Institute Cost of Doing Business Index (2004 & 2005)

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Tax Incentive Programs Designed to Attract Venture Capital

- “A tax incentive program is a potential “black hole”, because it is a future benefit of unknown proportions, which is determined by the favored taxpayer’s interpretation of what the tax credit should be, and is claimed on a tax return which is confidential”.

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Tax Incentive Programs Designed to Attract Venture Capital (cont'd)

As quoted from <u>2001–2003 Report, The Tax Review Commission to the State of Hawaii.</u>

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Types of Equity Capital

- Love capital
- Angel capital
- Venture capital

(Research by Dr. Daniel Sandler, Professor of Law at the University of Ontario)

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Tax Credit Programs

- Community Development Venture Capital Alliance (“CDVCA”) (2004) examined tax credit programs offered in 19 states

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Tax Credit Programs

- Direct Tax Credit – tax credit for an institutional or individual investor for an equity investment directly into a qualified business.

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Tax Credit Programs

- Seed capital credit –tax credit for an institutional or individual investor for an investment into a qualified investment fund making equity investments.

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Tax Credit Programs

- Contingent tax credit – tax credit given to investors only in the event that a state-sponsored fund or funds is unable to fulfill the financial returns contractually defined by its investors.

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Community Development Venture Capital Alliance (“CDVCA”) Report

- Programs offered in 19 states
- Most states located in Midwest or Mississippi Valley

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CDVCA Report

- 14 out of 19 states had per capita GDP below the national median
- All but 3 of the 19 states had difficulty attracting private venture capital
- 3 exceptions – NY, CO, NC

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PriceWaterhouseCoopers MoneyTree Report (2005)

- In 2005, private institutional venture capitalists invested $21.7 billion in the U.S.
- California and Massachusetts accounted for more than 58% of this total.
- Top 8 states > 80% of this total.

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PriceWaterhouseCoopers MoneyTree Report (2005)

- The average venture capital fund investment –or “deal size”—in 2005 was $7.4 million.

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Overview of Hawaii’s Qualifying High Technology (QHTB) Investment Credit

- An innovative program awarding nonrefundable tax credits to equity investors in a Qualified High Technology Business (QHTB).

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Definition of QHTB

- “a business, employing or owning capital or property, or maintaining an office, in this State; provided that:

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Definition of QHTB (cont'd)

- More than fifty percent of its total business activities are qualified research; and provided further that the business conducts more than seventy-five percent of its qualified research in this State ("the activity test"); or

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Definition of QHTB (cont'd)

- More than seventy-five per cent of its gross income is derived from qualified research; and provided further that this income is received from: (A) Products sold from, manufactured in, or produced in this state; or (B) Services performed in this State (the "gross income test").

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Measuring Activities Under the Activity Test

- Business activities are measured by the cost of these activities, the time spent on these activities, or other consistently applied reasonable basis.

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What Constitutes “Qualified Research”?

- “Qualified research” consists of one or more of the following activities:
- 1) research and development;
- 2) development and design of computer software;
- 3) biotechnology;
- 4) performing arts;

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“Qualified Research”, cont’d

- 5) sensor and optic technologies;
- 6) ocean sciences;
- 7) astronomy; or
- 8) nonfossil fuel energy-related technology.

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“Qualified Research”, cont’d

- Note: Act 215 changed the definition of “qualified research” as it relates to the “development and design of computer software”.

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“Research and Development” Under Act 221

- The business must perform research as defined in IRC Section 41(d).
- In general, this means research that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of technology or science.

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The Term “Qualified Research” is a Term of “Art”

- To be a QHTB, a business must be engaged in a “qualified research” activity. A business conducts “qualified research” by conducting any one of the above-listed eight activities.

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“Qualified Research”

- A business primarily engaged in research and development activity can be a qualified high technology business;

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“Qualified Research”

- So, too, can a business devoid of research and development activity.

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“Qualified Research”

- “Performing arts” businesses, such as film production, can qualify for the QHTB tax credit. Most other states that offer technology tax credits do not classify the act of making movies as a high technology activity.

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Computation of QHTB Investment Tax Credit

- Example: Taxpayer A invests $2,000,000 in a solely owned QTHB in 2001. Act 221—now Act 215– credits are:
- Year 2001……….$700,000
- Year 2002……….$500,000
- Year 2003……….$400,000
- Year 2004……….$200,000
- Year 2005……….$200,000

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Example

- Same facts as above, except Taxpayer A invests $2,500,000 in the QHTB. Taxpayer A is limited to $2,000,000 in credits over 5 years.

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QHTB Tax Credit Amount is Based Upon Amount Invested in QHTB

- Same facts as above, except, each year, the QHTB spends $100,000 on assets, $50,000 on operating expenses

- Credit is based upon $2,000,000 (the amount invested by Taxpayer A in the QHTB, not the amount spent by the QHTB).

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QHTB Tax Credit Amount is Based Upon Amount Invested in QHTB

- Although the QHTB paid out $750,000 for assets and expenses over this period, the QHTB credit is based upon the entire $2,000,000 equity investment.

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Credit Recapture

- Can occur upon the occurrence of certain events:
- Business no longer QHTB;
- Business (or interest in business) sold; or
- Taxpayer has withdrawn his or her investment from QHTB.

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Credit Recapture

- In 2001, a Taxpayer forms a solely owned Qualified High Technology Business (QHTB) by investing $2,000,000. However, on 1/1/2003, the Taxpayer sells his entire interest in the QHTB. In 2003, the Taxpayer's state income tax liability will increase by an additional $120,000.

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Credit Recapture

- In the above example, no Act 221 –now Act 215– credit in the year recapture occurs 2003 or in 2004-2005)

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Definition of “Investment”

- An investment will only be respected if the taxpayer has a reasonable expectation of (1) a return of capital and (2) a reasonable return on capital at the time the investment is made”

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Special Allocations

- Example: Taxpayer A invests $2.5 million and Taxpayer B, $500,000. The partnership is a QHTB. Under the terms of the partnership agreement, over a five-year period, $2,000,000 in total Act 221 credits will be allocated to Taxpayer A and $1,000,000 to Taxpayer B.

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Special Allocations

- Note: On an investment of $500,000, Taxpayer B is eligible for $ 1,000,000 in total Act 221 credits
- Note: Under Act 221/215, the “substantial economic effect rules” under the IRC do not apply for purposes of making special allocations of this credit.

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Abusive Transactions

- See T.I.R. No. 2003-01

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Economic Substance Doctrine

- Taxpayer must change economic position in a meaningful way; and
- Substantial non-tax purpose must exist.

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Business Purpose Doctrine

- Examine taxpayer’s intent
- Facts and circumstances issue

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Special Rules for Movie and Television and Entertainment Projects

- Numerous rules exist in this area.
- See Draft Report.

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2004 Legislation – Act 215

- Act 221 is now known as Act 215.

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Fees for Comfort Rulings

- Act 215 has established a new “Tax Administration Special Fund”
- See Department of Taxation Announcement No. 2005-19.

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“Development and Design of Computer Software” Under Act 215

- The term “development and design of computer software” now means the “development and design of computer software for ultimate commercial sale, lease, license or to be otherwise marketed, for economic consideration.

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Removal of “Liberal Construction” Language

- This constitutes a “big change” to prior law.

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Measuring the Costs and benefits of Hawaii's Act 221/Act 215 Investment Tax Credit

- Analyzing the tax policy implications of a given tax incentive is a process about which reasonable minds can differ.

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Measuring the Costs and benefits of Hawaii's Act 221/Act 215 Investment Tax Credit

- In the area of state tax policy, much remains unknown or unknowable.

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Measuring the Costs and benefits of Hawaii's Act 221/Act 215 Investment Tax Credit

- In part, this is due to a lack of access to usable taxpayer data.

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Analysis of Aggregated Taxpayer Data for the State of Hawaii

- In some cases, the Department of Taxation has aggregated certain taxpayer data.

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Privacy Concerns

- In other cases, the Department of Taxation has declined our requests in order to preserve the confidentiality of taxpayer information.

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Comparison of Hawaii's QHTB Tax Credit to Technology Tax Credits of Selected States

- No other state offers a 100 % credit based upon the amount contributed to a qualified high technology business.

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Venture Capital Data

- The Act 221 credit became law in 2001. From 2001-2005, private institutional venture capital firms invested the following amounts in Hawaii:
- 2001……….$ 37.8 Million
- 2002……….$ 2.9 Million
- 2003……….$ 16.6 Million
- 2004……….$ 25.6 Million
- 2005……….$ 15.3 Million

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Venture Capital Data

- For the period 1994-2005, Hawaii ranked 38th in its share of private institutional venture capital.
- Hawaiian companies received less than 1/10th of 1% of the total.

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Venture Capital Data

- For the period 2001-2005, Hawaii also ranked 38th. However, on a percentage basis, Hawaii's relative share of the total actually decreased during this period.

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Venture Capital Data

- Hawaii's relative share of private institutional venture capital investment from 1995-2005 was 0.098%. Its relative share from 2001-2005 was .08%.

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Venture Capital Data

- As mentioned earlier, in 2004, 19 states offered some form of tax credit incentive program. The top 7 states received more than 90% of the total venture capital funding received by these 19 states from 2001-2005.

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Venture Capital Data

- Hawaii ranked 13th out of 19 states. On a percentage basis, Hawaii’s relative share of the total was approximately 6/10th of 1%.

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Beneficiaries of Act 221/ Act 215

- Primary beneficiaries of Act 221 –now Act 215 credit-- appear to be insurance companies.

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Beneficiaries of Act 221/ Act 215

- Individual taxpayers are also major beneficiaries of this credit.

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Claimed Credits (and Other Matters).

- Some thoughts on claimed credits, claimable credits, credit carryovers, and other matters.

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To What Extent Do Future Claimable Credits Represent Future Tax Expenditures?

- Some companies may cease to be QHTBs
- Different types of taxpayers have different credit carryover profiles
- Present Value Analysis Issues (Choice of discount rates, etc).

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Utilization of QHTB Credit to Offset Various Taxes

- Individual Income Tax
- Corporate Income Tax
- Bank Tax
- Insurance Premium Tax

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How much has been invested?

	QHTB Investments ($million)	Credits Claimed ($million)
2000	3.94	0.39
2001	30.79	9.58
2002	81.87	26.19
2003*	68.49	38.87
2004	not yet available	not yet available
2005	not yet available	not yet available
Total	185.08**	75.03**

* Preliminary data

** Total only through Tax Year 2003

Source: Department of Taxation

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How can we assess the net benefit of Hawaii's QHTB Tax Credit?

- Most direct way is through data at the micro level

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Some indirect approaches

- Macro-data comparisons of Hawaii performance with US performance

- Aggregate micro-data analysis
  - Year over year response of economic measures to changes in QHTB investment
  - Cost-benefit program analysis

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QHTB Participation By Activity Reported by QHTB on Form N317

	QHTB	Jobs	Salaries Paid Total	Salaries Paid Average	Costs Incurred	Investments Received
2002	131	2209	$69,381,937	$31,409	$144,843,921	$118,237,560
2003	78	1980	$43,300,583	$21,869	$118,342,458	$68,529,705

Source: Department of Taxation

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Point Elasticity Response to Changes in QHTB Investment

2003 vs. 2002

	Elasticity
Change in QHTB Total Jobs	0.21
Change in QHTB Spending	0.38
Change in QHTB Salaries Paid	0.87

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Cost Benefit Analysis

- Stream of future costs
- Stream of future benefits
- Discount both streams to present value

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Estimated Credit Claims for Investments made through 2003 ➔ Cost Stream

2000	$0.39	million
2001	$9.58	
2002	$26.19	
2003	$38.87	
2004	$38.58	
2005	$38.88	
2006	$24.76	
2007	$7.85	
2008	$0.00	

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QHTB Gross Income, 2003

Activity	Gross Income
Computer Software	$16,944,160
Performing Arts	1,091,940
Multiple	28,048,135
Others	5,541,523
Total	$51,625,758

Source: Special Tabulation Department of Taxation

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Estimated Output from Investments made through 2003 ➔ Benefit Stream

2000	$1.35	million
2001	$11.92	
2002	$43.43	
2003	$51.63	
2004	.	
2005	.	
2006	.	
2007	.	

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Cost Stream and Benefit Stream multiplied to macro level

	Output	Earnings	State Tax
Computer Software(Publishing)	1.71	0.68	.097
Performing Arts	1.73	0.48	.087
Research & Development Services	1.96	0.67	.087
State and Local Government	1.98	0.94	.087
Personal Consumption Expenditures	1.49	0.42	.077

2002 State Input Output Study

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Benefit Cost Ratio: Tax Credits Reduce Other Government Spending

Type II Final Demand		Displacement None	10%	20%	40%
Output Effect	2003	1.03	0.93	0.82	0.62
	2007	1.36	1.22	1.08	0.81
Earnings Effect	2003	0.79	0.71	0.63	0.48
	2007	1.04	0.94	0.84	0.63
State Tax Effect	2003	1.22	1.05	0.89	0.60
	2007	1.60	1.42	1.24	0.90
Jobs Effect /1	2003	0.79	0.71	0.63	0.47

1/Jobs not subject to discount

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Benefit Cost Ratio: Tax Credits Offset by Increased Personal Income Tax

		Displacement			
Type II Final Demand		None	10%	20%	40%
Output Effect	2003	1.35	1.22	1.08	0.81
	2007	1.78	1.60	1.43	1.07
Earnings Effect	2003	1.77	1.60	1.42	1.06
	2007	2.34	2.10	1.87	1.4
Tax Effect	2003	1.37	1.06	0.80	0.41
	2007	1.81	1.44	1.12	0.61
Jobs Effect /1	2003	1.47	1.32	1.18	0.88

1/ Jobs not subject to discount

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Job Creation and the QHTB Investment Tax Credit

- A number of Act 221/215 “success stories” exist.
- However, the total change in technology jobs in Hawaii after 2001 yields a mixed picture.

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Technology Sector Job Counts and Wages, 2001-2004 (preliminary DBEDT, Aug 2006)

	Measure	YEAR 2001	2002	2003	2004	% Change 2001-04
Technology	Jobs	13,463	13,376	13,104	13,106	-2.7%
	Wages ($mill)	671	680	696	728	8.5%
	Ave Wage	49,889	50,883	53,159	55,606	11.5%
Private Sector	Jobs	446,032	444,376	454,240	467,969	4.9%
	Wages ($mill)	13,292	13,750	14,515	15,721	18.3%
	Ave Wage	29,802	30,943	31,956	33,596	12.7%
Tech Share of Private Jobs		3.0%	3.0%	2.9%	2.8%	
Tech Share of Private Wages		5.1%	4.9%	4.8%	4.6%	

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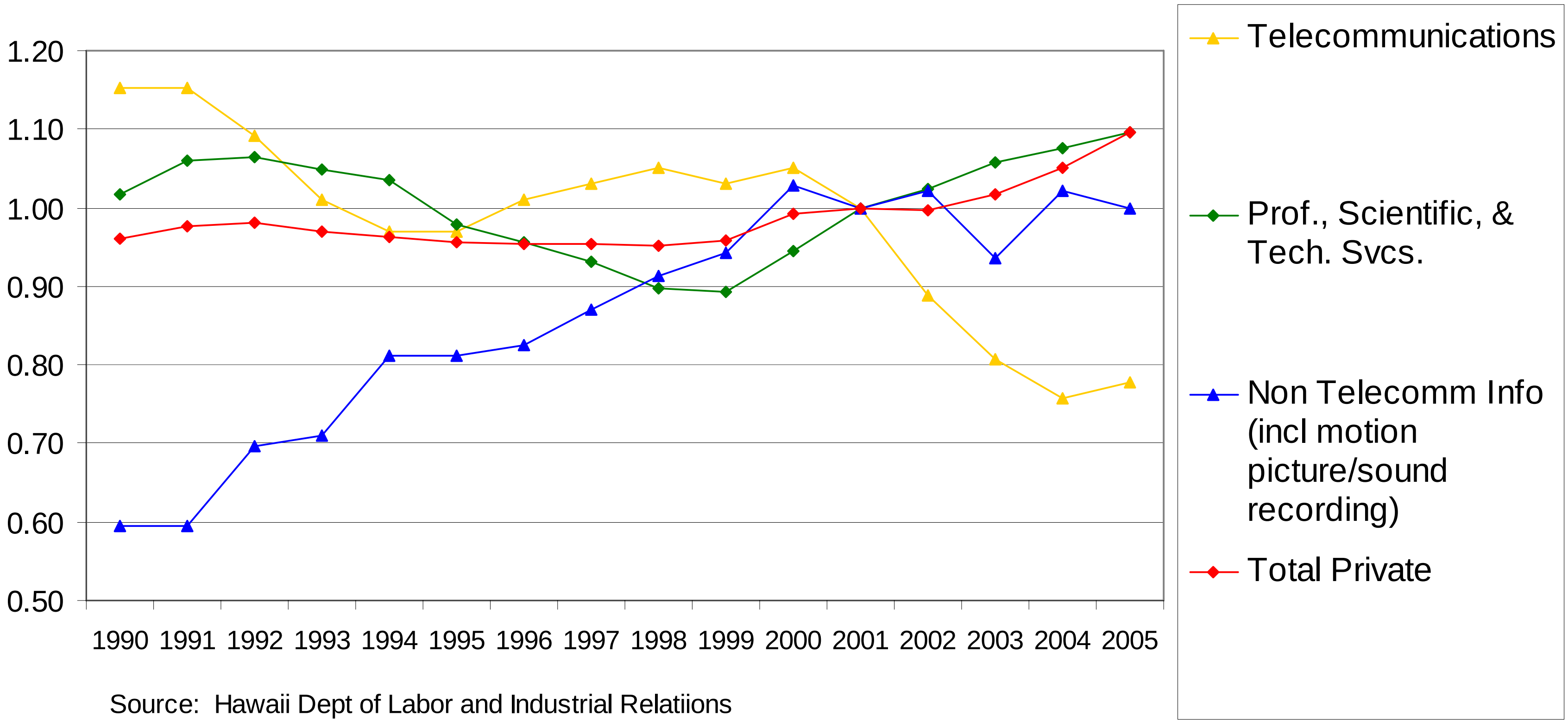
Hawaii Job Count by Industry



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Enforcement Issues

- Many enforcement issues exist as a result of the Act 221 --now Act 215-- credit.

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