

HAWAII TECHNOLOGY TAX INCENTIVES

HB 2396 CD1 (2004 Legislative Session)

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In 2001, Hawaii substantially expanded on technology tax incentives enacted in previous years. Act 221 was designed to increase the growth momentum in Hawaii for technology industries, and to attract the attention of technology companies and investors worldwide looking for expansion and investment opportunities. Many of the incentives had a five-year life. Act 221 has generated serious interest nation-wide by those with an affinity for Hawaii and have until recently put off serious due diligence. HB 2396 CD1 (SLH 2004) made amendments to Act 221 to extend the benefits of key incentives for another five years, and to tighten up on some eligibility requirements. Liberal construction is repealed. If enacted into law, the changes by HB 2396 are generally effective July 1, 2004 with a limited grandfather for completed transactions based on existing rulings.

100% high tech investment credit (now extended thru December 31, 2010)

Act 221 provides for a rich high tech investment credit. Structured as a 100% return on cash investments in a qualified high tech business (QHTB) on a front-loaded basis over 5 years—35% credit in the year of investment, 25% in the following year, 20% in the second year following, then 10% each in the third and fourth year following. The credit is designed to give a full 100% return for investments up to \$2 million per year per QHTB. If the QHTB fails to qualify as such or if the investment is sold or withdrawn, in any year during the 5-year period, there will be a recapture of 10% of the total tax credit claimed in the preceding two taxable years. Note that this credit is nonrefundable (applied against Hawaii income tax liability only) however, the allocation of credits among investors is permitted subject to limitations. The credit can be taken not only by individuals and corporations paying Hawaii income tax, but also by banks and insurance companies against their franchise and insurance premium tax, respectively.

One attractive feature of this incentive is the ability to allocate credits from one investor to another through partnerships or limited liability companies. This permits a trade of tax credits for equity. Effective July 1, 2004, the ability to allocate credits is subject to principles of economic substance and business purpose, with higher allocation ratios subject to higher scrutiny. It remains to be seen if the state will issue guidelines or factors on how these standards are to be applied.

Hawaii continues to have a shortage of local angel investment, and a more generous credit is necessary to attract interest in Hawaii-based technology companies. The modest recapture of tax credits if the business ceases to be a QHTB is designed to encourage investors to maintain interest in the viability of the company.

This credit significantly reduces the risk profile of an angel investment so that more Hawaii individuals will consider investing in tech companies for the first time. For active angels, the credit will return funds that could be made available for second or third round investments. Combined with the lower valuations prevalent in today's market, the credit will permit investors to fund less money for the same return. Out-of-state investors will have more confidence in Hawaii companies when they see higher participation by local investors.

QHTB definitions

Many of the tax incentives apply to QHTBs, including the high tech investment credit (and now the 20% research and development credit discussed below). A QHTB is defined as defined as a business that conducts more than 50% of its total activities in "qualified research" (for the investment credit, more than 75% of its qualified research must be done in Hawaii). "Qualified research" is a defined term and means research & development (R&D) work, computer software development, biotechnology, sensor and optic technologies, ocean sciences, astronomy, non fossil fuel energy-related technology, or performing arts products. These categories play on Hawaii's unique geography, natural resources, and culture. Encouraging growth in these sectors helps to strengthen and diversify our economy in a way that need not threaten Hawaii's environment or way of life.

Effective July 1, 2004 the definition for software development is modified, as follows:

“The development and design of computer software for ultimate commercial sale, lease, license or to be otherwise marketed, for economic consideration. With respect to the software’s development and design, the business shall have substantial control and retain substantial rights to the resulting intellectual property.”

[[Old definition—“The development and design of computer software using fourth generation or higher software development tools or native programming languages to design and construct unique and specific code to create applications and design databases for sale or license.”]]

Generous R&D refundable income tax credit (now sunsets December 31, 2010)

Hawaii’s 20% refundable credit on top of the federal 20% credit is already generous but does it one better by being refundable. Nevertheless, due to their smaller scale of operations, most Hawaii technology companies are limited in the amount of the credit that can be taken. This is because federal rules limit the 20% credit to increased R&D expenditures year over year. Act 221 decoupled Hawaii’s version of the R&D credit from the federal limitations so that all qualifying expenses each year will count toward the credit, not just the incremental increase. The combined Hawaii and federal credit work to make an investment in Hawaii QHTBs devoted to research work less risky. Note: This is an evolving area of the law, i.e., recent case law and the issuance IRS regulations, such that qualification for this credit must be based on current interpretation of the law by the courts, IRS, and state.

Effective July 1, 2004, QHTB status is required as a condition to qualifying for this credit. As before, the research work must be performed in Hawaii and must be expended for activities that constitute the carrying on of a trade or business.

New Reporting and Certification Requirements (eff. July 1, 2004)

New procedures apply to both the 100% high tech investment credit and 20% research and development credit. Before March 31 of each year following the year in which an investment in a QHTB is made, or research activity conducted, every taxpayer must file a certified statement to the department of taxation of qualified investments or expenditures made in the previous year and the amount of tax credits claimed in the previous year. The department of taxation is directed to: (1) maintain names and addresses of taxpayers claiming the credits and the total amount of qualified investment costs upon which the credit is based; (2) verify the nature and amount of the qualifying investments; (3) total all qualifying and cumulative investments that the department certifies; and (4) certify the amount of the tax credit for each taxable year and cumulative amount of the credit. The department of taxation is to issue a certificate to the taxpayer verifying the information submitted. The taxpayer is to file the certificate with the taxpayer’s tax return. Fees may be charged to offset the costs of certification. The certification filing requirement is in addition to the 12-month filing deadline to claim the credits on forms provided by the state.

Technology infrastructure renovation income tax credit (now extended thru December 31, 2010)

Act 221 provides a 4% nonrefundable income tax credit for renovation work on office buildings that support high tech tenants by providing high volume digital or analog telecommunications, physical security systems, environmental systems, and backup power systems. Many existing office buildings do not have the necessary infrastructure to attract and support technology tenants. This provision provides an incentive to renovate existing buildings with improved cable and fiber access, telecommunications connectivity, backup power and environmental systems.

GET and PSC exemption for public IDCs (for income received 7/1/01 thru 12/31/05)

Act 221 exempts public Internet Data Centers (IDCs) from the general excise tax (GET) and public service company (PSC) tax. IDCs are defined as facilities designed to house data centers, operate continuously, have redundant utility systems, and provide Internet-related data and complex web hosting services.

GET related party exemption (eff. 7/1/01; no sunset)

The legislation expands the general excise tax related party exemption to include IT services, use of software and hardware, and database management services. To effect economies of scale, one entity in a group of

related entities often incurs the cost of technology for its entire group. The value of these inter-company services will no longer be subject to the GET.

Stock option income tax exclusion (eff. 2001; no sunset)

The stock option income tax exemption was expanded by Act 221 to include stock options issued by the holding company of a QHTB, and to include equity interests in entities other than corporations. Startup technology companies use stock options to attract and retain qualified personnel. This provision takes away the income tax as a barrier to entry for those with such options, and helps to retain that talent in Hawaii.

Royalty income tax exclusion (eff. 2001; no sunset)

No major changes here except technical ones to ensure that the exclusion conforms to IP arrangements for performing arts products. The performing arts products activity previously limited to the royalty exclusion is now expanded to include all QHTB tax incentives.