



UNIVERSITY OF HAWAI'I SYSTEM

TESTIMONY

H.B. 2396 HD2 – RELATING TO CAPITAL INVESTMENTS

Testimony Presented Before the
Senate Committee on Science, Arts, and Technology
and
Senate Committee on Economic Development
March 18, 2004

By

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Testimony Presented Before the
House Committee on Finance
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Chair Ige, Chair Fukunaga and Members of the Committees:

I would like to present testimony in support of this bill with amendments. I will focus my remarks on the section regarding the proposed 20% tax credit for business –research institute R&D projects.

Industry-university collaborative research is one of the primary drivers behind successful technology centers around the nation, such as the Bay Area, Boston, Research Triangle, and San Diego. The standard measure of the extent of industry-university research collaboration is the percentage of university research that is financed by industry. About 6.75% of all research at the top 100 universities in the U.S is funded by industry. UH is among these top 100 universities, but only about 2.5% to 3.5% of our research is funded by industry. Likewise, while Hawaii companies are very successful in getting federal SBIR grants, Hawaii has one of the lowest rates in the nation for obtaining federal STTR grants, which fund industry-university R&D projects for commercialization. These are clear indications that industry is not leveraging the R&D assets at UH and other research institutes in Hawaii.

Part of the reason for this is the fact that Hawaii's technology companies have insufficient resources to finance R&D. According to the National Science Foundation, Hawaii has the lowest percentage of industry R&D financed by non-

federal sources. About 90% industry R&D in the U.S. is financed by non-federal sources like private investment, sales, and retained earnings. In Hawaii, only 25% of industry R&D is financed by non-federal sources. Our heavy reliance on federal funding for industry R&D suggests our companies lack enough discretionary, private resources to pursue their own, internally-generated goals for innovation. State tax incentives that help them stretch their limited research dollars will strengthen their capacity to innovate.

UH proposes the following amendments to strengthen HB 2396's ability to stimulate more industry sponsored research at Hawaii research institutes.

1. The 20% tax credit for business-research institute R&D projects should be made a refundable credit to provide more incentives for companies without Hawaii tax liabilities to collaborate with Hawaii research institutes, particularly those smaller local technology companies within Hawaii that do not yet have profits.
2. Businesses should be eligible for both the R&D credit for QHTBs and the Business-Research Institute tax credit, so long as they meet all applicable criteria and the value of their QHTB R&D tax credit for a project would be deducted from their qualified expenses for that same project when applying for a Business-Research Institute credit. Under the current version of HB 2396, companies would only be eligible for one, but not both, of these R&D tax credits for any given R&D project they undertake. QHTBs are the quintessential types of companies that we should be trying to encourage to work more closely with our State's research institutes. The fiscal impact of allowing QHTBs to apply for both credits for a given R&D project would likely be very small, since they tend to have modest research budgets and contract out only a small amount of their research. Based on figures from UH Research Activities, we estimate that less than \$100,000 of Business-Research Institute tax credits would have been

claimed during FY 2002-03 for QHTB sponsored projects at UH if this legislation was already in place.

Overall, HB 2396 is a well-developed package of incentives that will help Hawaii's technology sector get to the next level. The combination of capital formation and R&D tax credits will enable technology companies to continue to grow in Hawaii and better leverage the R&D infrastructure at UH and other institutions. HB 2396 is particularly helpful to the development of the biosciences industry around Kakaako, since biotech companies are very dependent on venture capital, and on research at medical schools. The early years of any biotechnology company are focused on research. The ability to access venture capital and stretch their research budgets is crucial to their viability. The proposed tax credit for industry research at UH and other institutes is also a valuable incentive for larger R&D companies to consider opening operations in Hawaii.

Specific language regarding these amendments is included in the attached mark-up text.

Thank you for the opportunity to comment on this bill.

Proposed Amendments to HB 2396 (Business-Research Institutes Tax Credit Section)

Submitted by James Gaines, Interim Vice-President for Research, University of Hawaii

SECTION 3. Chapter 235, Hawaii Revised Statutes, is amended by adding a new section to be appropriately designated and to read as follows:

"§235- Tax credit for business-research institute R&D projects. (a) There shall be allowed

to each taxpayer who is a qualifying corporation, subject to the taxes imposed by this chapter, a ~~non~~refundable business-research institute tax credit in the amount of twenty per cent of all qualified expenditures made during a taxable year in which the qualifying corporation is under contract with an eligible research institute to have scientific research and/or experimental development conducted., provided the qualifying corporation did not claim any tax credit for those expenditures claimed in this section. If the qualifying corporation claims a tax credit for research activities as allowed elsewhere in Chapter 235, that credit shall be deducted from their qualified expenditures for determining the tax credit for business-research institute R&D projects. The credit allowed under

this section shall be claimed against the net income tax liability, if any, for the

taxable year in which the credit is claimed. If the tax credit under this section exceeds the taxpayer's income tax liability, the excess of the credit over liability may be carried forward until exhausted.

(b) If a corporation is a member of a partnership at the end of a fiscal period, and that partnership qualifies for the business-research institute tax credit under this section, then the corporation is deemed to be a qualifying corporation and can calculate the tax credit for the taxable year that may reasonably be considered to be the qualifying corporation's share of the qualified expenditures.

(c) The director of taxation shall prepare forms as may be necessary to claim a credit under this section. The director may also require the taxpayer to furnish information to ascertain the validity of the claim for credit made under this section and may adopt rules necessary to effectuate the purposes of this section pursuant to section chapter 91.

Every qualified taxpayer, no later than March 31 of each year in which qualified costs were expended in the previous taxable year, shall submit a written, certified statement to the director of business, economic development, and tourism, identifying:

- (1) Qualified costs, if any, expended in the previous taxable year; ~~and~~
- (2) Other State tax credits, if any, claimed for research activities funded by (c)(1) above; and
- (3) The amount of tax credits claimed pursuant to this section, if any, in the previous taxable year.

(d) The department of business, economic development, and tourism shall:

- (1) Maintain records of the names of the taxpayers claiming the credits in subsection (a);
- (2) Obtain the amount of the qualifying costs or expenditures;
- (3) Total all qualifying and cumulative costs or expenditures that the department of business, economic development, and tourism certifies; and
- (4) Certify the amount of the tax credit for each taxable year and cumulative amount of the tax credit.

Upon each determination, the department of business, economic development, and

tourism shall issue a certificate to the taxpayer verifying the qualifying costs or expenditure amounts, the credit amount certified for each taxable year, and the cumulative amount of the tax credit during the credit period. The taxpayer shall file the certificate with the taxpayer's tax return with the department of taxation. Notwithstanding the department of business, economic development, and tourism's certification authority under this section, the director of taxation may audit and adjust certification to conform to the facts.

(e) The total of all qualified expenditures made by a corporation under an eligible contract shall be reduced by any contribution that the corporation, any shareholder of the corporation, any partnership of which the corporation is a member, any partner in that partnership or any person not dealing at arm's length with the corporation or a shareholder of the corporation has received, is entitled to receive or can reasonably be expected to receive from the eligible research institute that entered into the eligible contract, a person who performs scientific research and experimental development that is to be carried out under the contract or a person who does not deal at arm's length with either eligible research institute or the person who performs scientific research and experimental development.

(f) Notwithstanding subsection (e), if under the terms of an eligible contract between an eligible research institute and a corporation or partnership, the eligible research institute directly funds part of the cost of performing the scientific research and experimental development that is to be carried out under the contract, the expenditures made by the institute in performing the scientific research and experimental development shall not be considered to be a contribution if:

- (1) The financial obligations of the corporation or partnership under the contract are not reduced by the amount of any expenditures made by the eligible research institute;
- (2) The expenditures made by the eligible research institute are not payments made to or at the direction of the corporation or partnership; and
- (3) There is an agreement in writing between the eligible research institute and all other persons who are parties to the eligible contract that provides the terms and conditions under which the eligible research institute would be entitled to recover the amount of its expenditures.

(g) Subsection (e) does not apply in respect of the provision of goods and services in the ordinary course of a business carried on by the corporation or partnership if:

- (1) In the case where the corporation or partnership, or another person who does not deal at arm's length with the corporation or partnership, acquires the goods or services, the price paid by the corporation, partnership or person for the goods or services is not less than their fair market value; and
- (2) In the case where the corporation or partnership, or another person who does not deal at arm's length with the corporation or partnership, is providing the goods or services:

- (A) The price for the goods or services is not greater than their fair market value, and
- (B) The expenditures made to acquire the goods or services do not form part of the expenditures made by the eligible research institute for scientific research and experimental development under the eligible contract.

(h) An eligible research institute is deemed for the purposes of this section, to carry out scientific research and experimental development, if that scientific research and experimental development is carried out by a wholly-owned and controlled non-profit subsidiary of the eligible research institute, and if the scientific research and experimental development activities are required to be carried out under an eligible contract entered into by the eligible research institute.

(i) If an eligible research institute that has entered into an eligible contract

with a corporation enters into a contract with another institute that is an eligible research institute or a specified person and under that second contract the other institute performs part of the scientific research and experimental development that is to be carried out under the eligible contract or the specified person carries out part of the work required to be carried out under the contract, the scientific research and experimental development carried out directly by the other institute or the work carried out by the specified person is deemed to be carried out directly by the eligible research institute under the eligible contract.

(j) As used in this section:

"Contribution" means in respect of an eligible contract, an amount that is subtracted from an eligible contract and is:

(1) A payment in money, a transfer of ownership of a property, an assignment of the use of property or of a right to use a property or any other benefit or advantage in any other form or manner, other than a property resulting from scientific research and experimental development undertaken under the eligible contract

~~(2) A former, present or future right in the proceeds of disposition of part of or all of the intellectual property arising from the scientific research and experimental development undertaken under the eligible contract;~~

(3) A reimbursement, compensation or guarantee; or

(4) A loan or loan guarantee.

"Corporation" means a legal business entity including but not limited to, corporations, limited liability companies, and partnerships.

"Corporation connected to an eligible research institute" means a corporation and eligible research institute at any time during the term of the eligible contract or during the twenty four months before the contract was entered into,

(1) The eligible research institute owned, directly or indirectly in any manner whatever, shares of the capital stock of the corporation that:

(A) Carry more than ten per cent of the voting rights attached to voting securities, within the meaning of the Securities Act, of the corporation, or

(B) Have a fair market value of more than ten per cent of the fair market value of all of the issued shares of the capital stock of the corporation;

(2) The eligible research institute and the corporation were members of the same partnership, except as limited partners in an investment partnership, or did not deal at arm's length;

(3) A partnership of which the eligible research institute is a member owned, directly or indirectly in any manner whatever, any of the shares of the corporation; or

(4) The corporation and the eligible research institute are connected under rules prescribed by the regulations.

"Eligible contract" means:

(1) A contract entered into by a qualifying corporation with an eligible research institute, if under the terms of the contract, the eligible research institute agrees to directly perform in Hawaii scientific research and experimental development related to a business carried on in Hawaii by the qualifying corporation; and

(2) The corporation or partnership is entitled to exploit the results of the research and development carried out under the agreement.

(3) The project involved is for scientific research and experimental development where the end result is either patentable, or significantly enhances the technical strengths of an existing patented invention or discovery. Excluded activities shall include:

(a) Market Research

(b) General Surveys

- (c) Environmental impact studies or reports
- (d) Testing analysis of equipment or products for the purposes of quality or quantity control
- (e) Conferences or seminars

"Eligible research institute" means:

- (1) A Hawaii university or Hawaii college of applied arts and technology;
- (2) A nonprofit corporation for scientific research and experimental development; or
- (3) A hospital research institute that:
 - (A) is a Hawaii hospital or;
 - (B) is a non-profit corporation for scientific research and experimental development that is affiliated with a Hawaii hospital with which it has entered into an agreement so that the teaching staff from the hospital and students in the health professions may actively participate in and receive educational benefits from the research activities.

"Employee connected to corporation" means an employee of the eligible research institute that at any time during the term of the eligible contract or during the twenty-four months before the corporation entered into the eligible contract and the employee or a person who does not deal at arm's length with the employee owned, directly or indirectly in any manner whatever, shares of the capital stock of the corporation that

- (1) Carry more than ten per cent of the voting rights attached to voting securities, within the meaning of the Securities Act, of the corporation, or
- (2) Have a fair market value of more than 10 per cent of the fair market value of all of the issued shares of the capital stock of the corporation;

"Qualifying corporation" means a for-profit corporation or partnership that:

- (1) Conducts business in Hawaii in the taxable year through a permanent establishment in Hawaii;
- (2) Is under contract with an eligible research institution during the taxable year in which the tax credit is claimed;
- (3) Is not connected in the taxable year to the eligible research institute that entered into the eligible contract or to any other eligible research institute that carries out the scientific research and experimental development that is to be performed under the eligible contract; and
- (4) Is not controlled directly or indirectly during the twenty-four month period prior to the eligible contract, by:
 - (A) A trust, if any of the capital or income beneficiaries of the trust in an eligible research institute referred to in subsection (b)(3), or
 - (B) A corporation carrying on a personal services business.

"Qualified expenditure" means:

- (1) An expenditure made under an eligible contract;
- (2) A payment of money made by the qualified corporation to the eligible research institute under the terms of the contract; and
- (3) An expenditure incurred by the qualified corporation in respect of scientific research and experimental development carried on in Hawaii directly by the eligible research institute.

(k) This section shall apply to taxable years beginning after December 31, 2004, and shall not apply to taxable years after December 31, 2010. Credits authorized under the Hawaii business-research institute tax credit will be limited to a total of \$2,000,000 million per taxable year. The maximum tax credit a corporation or an associated group of corporations can claim is \$500,000.

In the event that total claims exceed \$2,000,000 for any one calendar year, the department of business, economic development, and tourism will provide certification for credits on a pro rata basis for all claims submitted for that taxable year. Should a corporation not receive the full amount of credits for which it is eligible for a given taxable year, it may file a claim for the

balance of credits in subsequent years, no later than 2012. The total credits claimed under this Act, shall not exceed \$10,000,000."

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