

PLAZA CLUB HIGH TECH LUNCHEON PRESENTATION

November 10, 2004

Prepared by the Department of Taxation
FOR DISCUSSION PURPOSES ONLY

I. ACT 215 CERTIFICATION

Act 214 establishes a new Tax Administration Special Fund and authorizes DOTAX to charge fees for certifying the high technology business investment tax credits and research activities tax credit, and providing comfort letters to businesses to be deposited into this Special Fund to offset the costs associated with issuing comfort letters, and certifications for the high technology business investment credit and research activities credit.

- A. Act 215 requires DOTAX to administer this certification process and authorizes DOTAX to assess and collect a fee for certification as well as comfort letter rulings. **The certification process applies to qualified investments and expenditures made after June 30, 2004.**
- B. The main purpose of certification is to gather information. Taxpayers are required to submit certified statements to Director before March 31 of each year. With limited processing time (as little as 20 days), the purpose of the certification process should be information gathering, rather than preliminary audit. Substantial investigation into credit claims is not possible with this time constraint and potentially high number of submissions.
- C. Certification as it applies to the High Tech Investment Credit.
 1. Each taxpayer shall submit a written, certified statement to the tax director identifying: the qualified investment expended in the previous taxable year; and the amount of investment tax credits claimed in the previous taxable year. HRS § 235-110.9(e).
 2. The statement must be submitted before March 31st (i.e., March 30th) of each year in which an investment in a qualified high technology business ("QHTB") was made in the previous taxable year. Time allowance will be given to *fiscal year taxpayers* (e.g., before the last day of the third month following the close of the taxable year).
 3. Under section 235-110.9(e), HRS, DOTAX must:
 - i. Maintain records of the names and addresses of the taxpayers claiming the investment credit and the total amount of the qualified investment costs upon which the credit is based;
 - ii. Verify the nature and amount of the qualifying investments;

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- iii. Total all qualifying and cumulative investments that DOTAX certifies;
 - iv. Certify the amount of the credit for each taxable year and cumulative amount of the credit; and
 - v. Issue a certificate verifying: Information submitted to DOTAX, including the qualifying investment amounts; the credit amount certified for each taxable year; and the cumulative amount of the credit during the credit period.
4. The taxpayer shall file the certificate with the taxpayer's tax return.
 5. DOTAX has prepared draft **Certification Form N-318B** that will be separate from other required high technology business investment credit forms, i.e., forms N-317, N-318, and N-318A.

The new form will contain the following elements:

- a. Certified Statement of the Taxpayer. What is the definition of "certified statement"? To certify means to authenticate or vouch for a thing in writing; or to attest as being true or as represented. We interpret this to mean signed by a duly authorized person (who will be subject to jurat on certification form).
 - b. Name, address, and SSN/EIN of taxpayer claiming the credit.
 - c. Nature and amount of qualifying investments.
 - d. Date the investment was made in the previous year.
 - e. Name of the QHTB that received the investment.
 - f. Credit allocation schedule.
 - g. Name of the special purpose entity ("SPE") if investment made through a SPE.
 - h. Disclosure of credit allocation ratio if a disproportionate share of credit is being allocated to taxpayer.
 - i. Language clearly stating that this is a preliminary certificate and taxpayer still subject to future audit (**DOTAX retains right to examine in future**).
6. Submission Procedures
 - a. Because DOTAX is required to verify the nature and amount of the investment and HRS § 235-1 requires that the investment be in cash, taxpayers shall submit evidence of such cash investment (e.g., cashiers check, personal check, etc.)
 - b. Industry suggested matrix filings by SPE (investment entity). Certification can be requested by an SPE or other

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investment entity to file the form and collect and pay over the fees for certification on behalf of its investors. The SPE will prepare a "matrix filing," collect certification fees from all investors/partners and submit all certificates to DOTAX.

- c. If certificate cannot be issued prior to taxpayer filing return, the taxpayer is still allowed to make a claim for the credit 12 months after close of taxable year to claim credit. Taxpayers should file a protective certificate before March 31st if not all information is available (e.g., provide good faith estimates).
- d. Frequency of Certification by DOTAX shall be once in the year in which the investment is made (for the 5-year credit schedule), unless some triggering event occurs, such as reallocation of credits between partners/members of investing entity.

D. Certification as it relates to the Research Credit

1. Each taxpayer shall submit a written, certified statement to the tax director identifying: the qualified expenditures expended in the previous taxable year; and the amount of research tax credits claimed in the previous taxable year. HRS § 235-110.91(d).
2. The statement must be submitted before March 31st (i.e., March 30th) of each year in which qualified research and development activity was conducted in the previous taxable year. Time allowance will be given to *fiscal year taxpayers* (e.g., before the last day of the third month following the close of the taxable year).
3. The taxpayer shall file the certificate with the taxpayer's tax return.
4. Under section 235-110.91(d), HRS, DOTAX must:
 - i. Maintain records of the names and addresses of the taxpayers claiming the research credit under this section and the total amount of the qualified research and development activity costs upon which the credit is based;
 - ii. Verify the nature and amount of the qualifying costs or expenditures;
 - iii. Total all qualifying and cumulative costs or expenditures that DOTAX certifies;
 - iv. Certify the amount of the tax credit for each taxable year and cumulative amount of the credit; and
 - v. Issue a certificate to the taxpayer verifying: Information submitted to DOTAX, including the qualifying costs or expenditure amounts; the credit amount certified for each

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taxable year; and the cumulative amount of the credit during the credit period.

5. DOTAX has prepared draft **Certification Form N-319A** that will be separate from other required research credit forms (e.g., N-319)

The form contains the following elements:

- i. Certified Statement of the Taxpayer. Same as Investment Credit.
 - ii. Name, address, and SSN/EIN of taxpayer claiming the credit.
 - iii. Nature and amount of qualified research expenses.
 - iv. Dates the expenses were incurred in the previous year.
 - v. Whether taxpayer is claiming the research credit on taxpayer's federal return
 - vi. Language clearly stating that this is a preliminary certificate and taxpayer still subject to future audit (**i.e., DOTAX retains right to examine in future**).
6. Submission Procedures. Generally same as Investment Credit, see Section I.C.6(c), *supra*.

II. FEES

A. Prior Discussions

With the certificate submission deadline of March 30, a March 30 submission would require DOTAX to provide the taxpayer with the certificate early enough for the taxpayer to submit the certificate with such taxpayer's April 20 tax return filing (the due date for individuals and calendar year corporations). The Tax Research and Planning Office estimates that there will be approximately 350 certificate submissions (200 Investment Credit and 150 Research Credit) for calendar year end 2004.

B. Investment Credit Fee Schedules – Alternatives

ALTERNATIVE 1: FIXED FEE

The fixed fee proposal consists of a flat \$500 fee for each taxpayer submission. This flat fee would be easiest to administer and generate annual revenue of \$20,000. An unfavorable consequence, however, would be the regressive nature of the fee.

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ALTERNATIVE 2: FLAT PERCENTAGE

The flat percentage fee schedule proposes X% rate multiplied by the amount of the investment. While this alternative may be less regressive than a flat fee, it may be more troublesome to administer for both taxpayers and DOTAX.

ALTERNATIVE 3: FIXED-FEE BASED ON TIME OF SUBMISSION

A sliding scale may be most appropriate, i.e., for certain flow-through investment entities (e.g., partnerships and LLCs treated as partnerships for net income tax purposes), a fixed fee of \$1,000 per "matrix filing" submitted prior to the 3rd Wednesday of January, and \$1,500 for each "matrix filing" submitted on or after the 3rd Wednesday of January.

Similarly, DOTAX proposes a fixed fee of \$100 for each separate taxpayer submission prior to the 3rd Wednesday of January, and \$150 for each separate taxpayer submission on or after the 3rd Wednesday of January. This arrangement would most closely approximate the amount of work required to process each submission. Basis for higher fee on or after the 3rd Wednesday of January is the overlap with Rules Office's responsibilities when the legislature is in session.

C. Research Credit Fee Schedules

Certification of Research Credit claims may require more attention than that of the Investment Credit, i.e., verifying the nature and amount of qualifying costs or expenditures. Due to the additional verification, a higher fee should be proposed, i.e., a fixed fee of \$400 for submissions prior to the 3rd Wednesday of January, and \$500 for submissions on or after the 3rd Wednesday of January.

Because the information necessary for applying for certification can only be provided by the QHTB claiming the credit, DOTAX is considering **requiring** the QHTB to do a "matrix filing" for all of its members or partners (if the QHTB is a flow-through entity).

III. OTHER AMENDMENTS MADE BY ACT 215

- A. Extends the for another five years:
1. Technology infrastructure renovation tax credit (4.0% nonrefundable), HRS § 235-110.51;
 2. High technology business investment tax credit (100% nonrefundable), HRS § 235-110.9; and
 3. Research activities tax credit (20% refundable), HRS §110.91.

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- B. Removes language that high tech incentives be "liberally" construed by tax officials.
- C. Establishes the State Private Investment Fund within the Hawaii Strategic Development Corp;
- E. Amends the definition of computer software: "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."
- F. Limits the use of research activities tax credit to Qualified High Technology Businesses (QHTB).
- G. Establishes guidelines for multiples of the high technology business investment tax credit under HRS Section 235-110.9:
 - 1. A multiple of 1.5/1.0 over the five (5) year schedule is presumed to satisfy the doctrines of economic substance and business purpose.

For example, $1.5 \times .35 = .525$ for first year, $1.5 \times .25 = .375$ for the second year, and so forth.
 - 2. A multiple greater than 1.5 but no more than 2.0/1.0 over the five (5) year schedule creates no presumption and may be reviewed by DOTAX for economic substance and business purpose.

For example, $1.6 \times .35 = .56$ for first year, $1.6 \times .25 = .40$ for second year, and so forth.
 - 3. A multiple greater than 2.0/1.0 shall substantiate economic "merit" [substance] and business purpose.