



Grant Thornton



Department of Taxation

Hawaii Research Tax Credits

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Introductions

- **Patrick Oki**, Partner, Audit & Advisory, Grant Thornton
 - Local leader of Hawaii high-tech consulting practice
 - Previously CFO of a Hawaii high-tech company
 - Assisted several high-tech companies in Hawaii
- **Mark Andrus**, Partner and National Leader of R&D Tax Credit Practice, Grant Thornton
 - Over 8 years experience with Hawaii R&D tax credits
 - Involved in federal and state legislative matters
 - Leader of audit defense teams

Introductions continued...

- **Carol Tom**, Senior Tax Associate, Hawaii High-Tech Consulting Practice, Grant Thornton
 - Attorney and accountant
 - Has spent significant portion of her career involved in the Hawaii R&D tax credits

- **Johnnel Nakamura**, Rules Officer, State of Hawaii Department of Taxation
 - Supervisor of rules office

Topics

- Background on Act 221/215 Tax Incentives
- Definition of a QHTB and Benefits
- Overview of Research Tax Credit
- Identifying Qualified Activities
- Identifying Qualified Research Expenditures
- Current Issues
- Questions and Answers

Background on Hawaii's Act 221/215 tax incentives

– What?

Investment Tax Credit

» A 100% return of investment dollars over a 5 year period

Research Tax Credit

» A refundable credit of 20% of "qualified research expenditures"

– Why?

Enacted 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

Tax Benefits

1. Investment credit – 100% recovery of investment over a 5 year period for investors with Hawaii tax obligation
2. R&D credit – 20% refundable credit for qualified R&D costs. May flow through to investors (if a flow through entity such as an LLC)

QHTB

Definition

Qualified High Technology Business (QHTB)

- More than 50% of its total business activities are qualified research; and provided that the business conducts more than 75% of its qualified research in Hawaii; or
- More than 75% of its gross income is derived from qualified research; and provided that this income is received from:
 - (A) Products sold from, manufactured in, or produced in Hawaii
 - (B) Services performed in Hawaii

QHTB

Definition

"Qualified Research" means:

1. The same as in IRC 41(d) (research and development);
2. Development and design of computer software;
3. Biotechnology;
4. Performing arts;
5. Sensor and optic technologies;
6. Ocean sciences;
7. Astronomy; or
8. Non-fossil fuel energy-related technology

How to get assurance that your company is a QHTB?

You can apply for a Qualified High Tech Business comfort ruling request with the Department of Taxation. This requires:

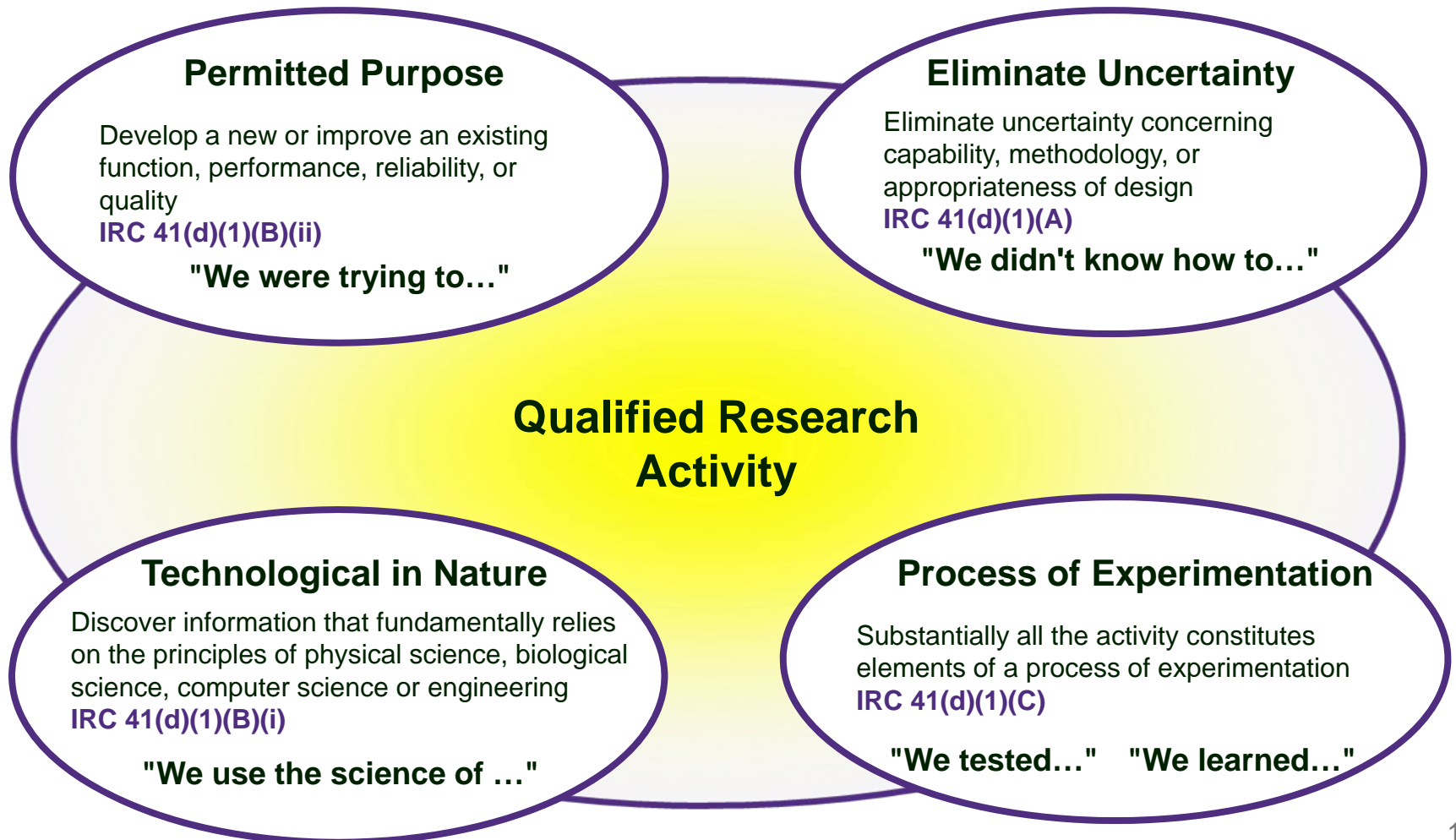
1. Description of company
2. Detailed discussion of company's qualifying activities
3. How the company meets the definition of a "QHTB"
4. Analysis of applicable law and application of law to the facts
5. Description of business and future business plans.

Research Tax Credit Overview

- Claiming R&D credits requires two steps
 - Step 1: Identify qualified activities
 - Step 2: Identify qualified costs
- General 4-Part Qualification Test
- Calculation



Identifying Qualified Activities – 4-part Test



Examples of Qualified Research

- Product Development
 - Designing new products
 - Enhancing existing products
- Software Development
 - Modeling and designing new software
 - Writing, programming, and testing new code
 - Creating development tools
 - Modification or enhancements to purchased software

Examples of Qualified Research

- **Manufacturing Environment**
 - Designing new process for production of new product
 - Introducing new technology into an existing production process
 - Using computers or robotics to automate tasks
 - Creating specialized tools, machinery, or fixtures
 - Process changes designed to accommodate new materials
 - Process improvements to achieve cost-reduction goals

Qualified Research Activities – Specifically Excluded

- research after commercial production
- adaptation of existing business component
- duplication of existing business component
- management functions, efficiency surveys, & market research

- routine data collection
- routine quality control testing
- research conducted outside of Hawaii
- social sciences, arts, or humanities research
- funded research

Qualified Research Expenditures

- **Wages:**
 - Form W-2 wages
 - Excludes 401(k), benefits, & overhead costs
- **100% of Supply costs:**
 - Items used or consumed in the qualified activity
- **65% of contract research:**
 - Where the taxpayer pays someone other than an employee to perform qualified research
 - Fees paid to consultants or engineering firms
 - The taxpayer must bear the economic risk (funding) and retain rights in the results of the research
 - Must be performed in Hawaii



Calculation:

Company X has the following expenditures for the 2006 year:

Wages:	\$300,000
Supplies:	\$100,000
Contract Research:	\$100,000
	<u>x .65</u>
	\$ 65,000
Total:	\$465,000
	<u>x .20</u>
R&D credit amount:	\$ 93,000



Current Issues

Dates To Watch For

- March 30 of each year if calendar year filer
 - Every taxpayer must apply for a certificate to take the Research Tax Credit on tax returns by filing Form N-319A
 - Certificate must be filed with the taxpayer's return
 - Fees will be charged
 - Fiscal year filer must file on or before the last day of the third month following the close of the fiscal year
- 12 months after year end
 - Taxpayers have 12 months after year end to file for Hawaii Research Tax Credit

Current Issues

Documentation

- IRS current audit methodology is to challenge R&D credits based on lack of documentation
- States are following the IRS lead
- Tax preparer standard has been changed such that higher threshold must be met to put credits on returns
- Taxpayers should evaluate documentation that is created during the development process and retain documents that address each technical issue related to R&D credit issues.
- Grant Thornton can help with this process

Current Issues

Department of Taxation Update

- Comfort letter ruling process and issues
- Tax Information Releases (TIR)
- Suggestions for taxpayers
- Other

Questions, answers, discussion....

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