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TAX INFORMATION RELEASE NO. 2007-04

RE: DEPARTMENT OF TAXATION POLICIES RELATING TO HIGH TECHNOLOGY INVESTMENT TAX CREDIT ALLOCATIONS

The purpose of this Tax Information Release is to provide taxpayers and tax professionals with guidance on the Department of Taxation's policies regarding its analysis of credit ratios for the high tech investment credit allowed under HRS § 235-110.9. This Tax Information Release explains these policies, which apply to certain credit ratios of 2:1 or less. *Please see* Act 215, Session Laws of Hawaii 2004 (hereinafter "Act 215").

I. ALLOCATION OF HIGH TECH INVESTMENT CREDIT WITHOUT REGARD TO ECONOMIC SUBSTANCE AND BUSINESS PURPOSE PERMITTED WITH CERTAIN LIMITATIONS.

In general, § 235-2.45(d)(1), HRS, allows partnerships or limited liability companies treated as partnerships for net income tax purposes (LLCs) to allocate the investment credit among such partners without regard to the substantial economic effect rules of § 704(b)(2) of the Internal Revenue Code. Thus, partnerships are allowed to disproportionately allocate the investment credit without regard to a partner's equity interest in the partnership or without regard to allocations of losses or expenses. As a result of Act 215, these allocations are subject to certain restrictions.

Act 215 defines “investment tax credit allocation ratio” to mean, with respect to a taxpayer that has made an investment in a qualified high technology business (QHTB), the ratio of:

(1) The amount of the credit that is, or is to be, received by or allocated to the taxpayer over the life of the investment, as a result of the investment; to

(2) The amount of the investment in the QHTB.

Because it is possible to receive allocations of the investment credit in excess of the actual investment amounts made, Act 215 established limitations on larger credit allocations by requiring a taxpayer to demonstrate that investments in a QHTB satisfy the common law doctrines of economic substance and business purpose when credit ratios reach certain multiples. Specifically, § 235-

110.9(h), HRS, provides that:

1. For credit ratios of 1.5:1.0 or less (that is, if the investor receives investment credits in a ratio of 1.5 or less for every dollar invested), there exists a presumption that a transaction satisfies the doctrine of economic substance and business purpose.

2. Transactions involving credit ratios greater than 1.5, but not more than 2.0, do not create a presumption of satisfying the doctrines of economic substance and business purpose and may be reviewed by the department for relevant satisfaction of these concepts.

3. Taxpayers investing in a QHTB and receiving credit ratios greater than 2.0 of credit for every dollar invested are required to substantiate economic substance and business purpose.

A. Economic Substance and Business Purpose Doctrines

The common law doctrines of economic substance and business purpose are discussed in Tax Information Release 2003-01. This Tax Information Release 2007-04 provides further clarification on how the Department will apply the doctrines to investment transactions seeking qualification under § 235-110.9, HRS, as amended by Act 215. Though there is a lack of uniformity in the circuit courts regarding the proper application of the economic substance doctrine, Act 215 expressly includes both economic substance and business purpose as threshold tests. Thus, the Department interprets the statute to apply the doctrines as a conjunctive test, and therefore, requires both elements to be substantiated.[1]

Generally, it is the taxpayer's burden to satisfy the economic substance and business purpose doctrines when such application involves a tax benefit authorized by the government. The following subparagraphs provide taxpayers with the Department's analysis and the necessary elements that must be developed, established, and subsequently substantiated in order to demonstrate to the Department's satisfaction economic substance and business purpose—

1) Developing Economic Substance

Hawaii state courts have not expressly adopted a specific economic substance and business purpose test. However, the United States Court of Appeals for the Federal Circuit has recently provided a clear, concise, and up-to-date analysis of the economic substance test. This test is discussed in *Coltec Industries, Inc. v. US*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S.Ct. 1261 (2007) (cited at length and analysis supported, *HJ Heinz & Subs v. US*, 76 Fed. Cl. 570 (2007)). The Department will analyze claims of economic substance based upon the *Coltec* determination. In order to satisfy the principles of economic substance and business purpose, a taxpayer must demonstrate the following:

- "First, although the taxpayer has an unquestioned right to decrease or avoid his taxes by means which the law permits, *Gregory*, 293 US at 469, the law does not permit

[1] Some courts apply a conjunctive test; other courts find that the existence of either business purpose or economic substance would be sufficient to respect the transaction; and still other courts treat the two doctrines as factors to consider in determining whether a transaction serves any practical economic purpose other than creating tax benefits.

the taxpayer to reap tax benefits from a transaction that lacks economic reality." This means that economic substance cannot be sustained where there is simply no business purpose or economic function of a transaction other than to reduce taxes. Transactions that do not vary the economic benefits and burdens of the taxpayer's position are to be disregarded.

- "Second, when the taxpayer claims a [tax benefit], it is the taxpayer who bears the burden of proving that the transaction has economic substance."

- "Third, the economic substance of a transaction must be viewed objectively rather than subjectively." This requires demonstration of the economic reality of the transaction through impartial means. Subjective motivations proffered by a taxpayer will be saved for the "Business Purpose" analysis, discussed *infra*. In short, the analysis is whether there is economic reality and whether the transaction affects the taxpayer meaningfully in an economic way.

- "Fourth, the transaction to be analyzed is the one that gave rise to the alleged tax benefit." This means that the taxpayer must substantiate each step of a compound transaction and that a taxpayer cannot sustain economic substance by merely arguing the transaction, as a whole, changes the taxpayer's economic position.

- "Finally, arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny." This stands for the proposition that inter-company transactions are, in many tax-motivated instances, arranged solely to enjoy a tax benefit not otherwise intended. A taxpayer must demonstrate that its transaction has created a genuine obligation for all parties involved. The presence of independent third parties will favor the taxpayer's position versus the use of familial transactions.

The foregoing analysis developed in the recently passed *Coltec* decision does not supercede the economic substance analysis contained in TIR 2003-01. The inclusion of the *Coltec* analysis in this TIR 2007-04 demonstrates the analytical determination that the Department will expect in discerning economic substance, relying also on the principles set forth TIR 2003-01.

2) Developing Business Purpose

The taxpayer's burden of demonstrating a valid, nontax business purpose is subjective in nature. The business purpose analysis will include, among other factors discussed in TIR 2003-01, whether the taxpayer's committing of capital to the transaction was motivated only because of tax considerations, or whether the taxpayer had legitimate and reasonable nontax motivations.

3) Substantiating Economic Substance & Business Purpose

With respect to the economic substance and business purpose doctrines, the Department may consider these and other relevant factors in making its determination:

1. The promotional and informational materials provided by promoters (or others involved

in the transaction) to the investor or the investor's agents;[2]

2. The investor's investigation (personally or through independent agents[3]) into the non-tax financial and legal aspects of the transaction;
3. The investor's experience with similar transactions and/or the industry and personal knowledge of the equipment (*e.g.*, technology) and its use in industry;
4. Testimony or representations made by the investor concerning the business reasons for the investor's participation in the transaction and for the chosen legal structure;
5. Arms length independence of the negotiations between the investor and other parties to the transaction;
6. Whether the transaction involves independent third parties or whether the transaction involves related entities;
7. The investor's ongoing involvement and participation in monitoring the transaction after its commencement;
8. The investor's subjective and objective motivations for the investment;
9. The investor's expected and/or intended return on the investment (*e.g.*, whether the return was intended to be positive, negative, or neutral);
10. Length of the investment (*e.g.*, short sale or an up-front agreement for the longevity of invested funds and the agreed-upon return of capital);
11. Whether the investment, either as advertised, intended, or otherwise, was riskless; or
12. Whether the investment has a risk premium.

These factors require a facts and circumstances analysis, where no single factor is determinative, but rather, all factors will be considered. Importantly, substantiation of both economic substance and business purpose must be demonstrated to the satisfaction of the Department based upon the analytical framework set forth in this TIR 2007-04 and TIR 2003-01.

B. Department of Taxation's Policy Regarding Credit Ratios of 2:1 or Less; Safe Harbor

The economic substance and business purpose tests require a highly fact-intensive analysis of an investment transaction. In an effort to create certainty and predictability for the technology community and to ease administration of the requirements established by Act 215, the Department will not require a taxpayer to substantiate economic substance or business purpose for *certain* eligible transactions involving credit ratios of 2:1 or less. In order to qualify for safe harbor treatment, an investment transaction must satisfy both Test 1 and Test 2, as more fully discussed below—

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[2] Some promotional and informational materials that may be provided to the investor that the Department will consider in a favorable light are: the QHTB's 5-year budget; business plan updates and executive summaries; personal information regarding the founders of the QHTB and an explanation of the vision for the QHTB's research projects; overviews of the QHTB's research and development projects; list of grants received by the QHTB; and an executive summary of financial projections.

[3] Independent agents have no financial or referral relationship to the promoter.

SAFE HARBOR TESTS

TEST 1—No Frontloading of Credits Test

All taxpayers seeking safe harbor treatment must satisfy Test 1. In order to satisfy Test 1, the investor shall receive total investment credits ratably in accordance with the 5-year credit schedule provided by § 235-110.9(a), HRS.[4] For example, if the credit ratio is 2:1, each dollar invested in a QHTB shall yield the following credit amounts:

Scenario: Credit Ratio of 2:1

Year 1:	2.0 X $0.35	=	$0.70
Year 2:	2.0 X $0.25	=	$0.50
Year 3:	2.0 X $0.20	=	$0.40
Year 4:	2.0 X $0.10	=	$0.20
Year 5:	2.0 X $0.10	=	$0.20
Each $1 invested yields		**=**	**$2.00 in credits over 5 years**

Therefore, in order to satisfy Test 1, a taxpayer cannot frontload the additional credit received in a manner that exceeds the adjusted statutory credit schedule.

Credits received in a manner that substantially departs from Test 1 (*e.g.,* claiming a 2:1 income tax credit allocation ratio over a period of two years rather than the 5-year credit schedule provided by § 235-110.9(a), HRS), shall be reviewed for economic substance and business purpose, and will likely be audited and challenged by the Department. The Department's position is that tax credits shall be received over the 5-year credit schedule provided by § 235-110.9(a); and that income tax credit allocation ratios shall be subject to the investment tax credit allocation ratio guidelines set forth in § 235-110.9 and as otherwise provided by law.

For purposes of demonstrating the examples below, the following tables are provided:

TABLE 1—

Scenario: Credit Generated By SPE, LLC Investment ($300 Initial Year 1 Investment)

Year 1:	$300 X 35%	=	$105
Year 2:	$300 X 25%	=	$75
Year 3:	$300 X 20%	=	$60

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[4] Section 235-110.9(a), HRS, states, in part:
The tax credit shall be as follows:
(1) In the year the investment was made, thirty-five per cent;
(2) In the first year following the year in which the investment was made, twenty-five per cent;
(3) In the second year following the investment, twenty per cent;
(4) In the third year following the investment, ten per cent; and
(5) In the fourth year following the investment, ten per cent;
of the investment made by the taxpayer in each qualified high technology business, up to a maximum allowed credit in the year the investment was made, $700,000; in the first year following the year in which the investment was made, $500,000; in the second year following the year in which the investment was made, $400,000; in the third year following the year in which the investment was made, $200,000; and in the fourth year following the year in which the investment was made, $200,000.

Year 4:	$300 X 10%	=	$30
Year 5:	$300 X 10%	=	$30
$300 Invested		**=**	**$300 in credits over 5 years**

TABLE 2—

Scenario: Credit Allowed 1:1 Ratio (No Increased Allocations)

	($ Total Credit Generated from Table 1)	A's Credit ($100 Investment)	B's Credit ($200 Investment)
Year 1:	35% ($105)	$35	$70
Year 2:	25% ($75)	$25	$50
Year 3:	20% ($60)	$20	$40
Year 4:	10% ($30)	$10	$20
Year 5:	10% ($30)	$10	$20

TABLE 3—

Scenario: Credit Allowed 2:1 Ratio (Increased Allocation to A)

	($ Total Credit Generated from Table 1)	A's Credit at 2:1 Multiple ($100 Investment)	B's Credit ($200 Investment)
Year 1:	35% ($105)	$70	$35
Year 2:	25% ($75)	$50	$25
Year 3:	20% ($60)	$40	$20
Year 4:	10% ($30)	$20	$10
Year 5:	10% ($30)	$20	$10

EXAMPLE—A and B are each members in a special purpose entity, SPE, LLC, treated as a partnership for income tax purposes. A has invested $100 and B has invested $200. SPE, LLC has invested $300 in XYZ, Inc., a QHTB. SPE, LLC's investment generates a total of $105 in credit for Year 1, which may be allocated without regard to IRC § 704(b). In order to satisfy Test 1, A cannot claim any credit that exceeds the adjusted statutory schedule reflected against a 2:1 multiple for purposes of this TIR. Therefore, to satisfy Test 1 of the safe harbor, the most A can claim as a credit is $70 in Year 1.

EXAMPLE—Assume the same facts as above, except that the operating agreement provides that A will receive all of the $105 tax credit in Year 1, which was negotiated between A and B. A will not satisfy Test 1 and will not qualify for safe harbor treatment because $105 exceeds the $70 maximum credit allowed pursuant to the schedule for the maximum 2:1 ratio that is recognized under this TIR. To claim $105 in credit in Year 1, A must prove to the Department that its allocation in Year 1 of $105 satisfies the economic substance and business purpose doctrines.

TEST 2—Limited Equity Shifting Test

To satisfy Test 2, the investor shall retain at least half (50%) of the pro-rata equity interest of the investment in the QHTB. In other words, only half (50%) of the equity interest in the investment in the QHTB may be shifted from one partner or member of the investing entity to another partner or member (in exchange for higher shares of investment credits). In order to satisfy Test 2, an investor must retain at least 50% of its capital interest, as well as 50% of its profits interest.

> *EXAMPLE*—A and B have each invested $1,000 in SPE, LLC, a special purpose entity that has invested in XYZ, Inc., a QHTB, for a total investment of $2,000. Pursuant to the operating agreement, A is entitled to an increased multiple of credit allocation, equal to all of the income tax credits generated by this investment. The increased credit allocation is predicated upon A's relinquishment of not more than half of its capital interest and not more than half of its profits interest in SPE, LLC. (*e.g.*, shifting of capital account and/or profits interests in SPE, LLC is the form of equity shifting contemplated by Test 2). To satisfy Test 2, A must retain at least 50% of its initial 50% interest in SPE, LLC or 25% of the total investment in the QHTB.

Please note that this TIR does not discuss any federal or state income tax or general excise tax consequences of any shifts in equity.

QUALIFYING FOR SAFE HARBOR TREATMENT

In order to qualify for safe harbor treatment for satisfaction of the economic substance and business purpose principals, an investment transaction must satisfy both Test 1 and Test 2.

SAFE HARBOR SUMMARY

The Department will only recognize a taxpayer's claim for safe harbor treatment if both Test 1 (requiring the credit claim to be made ratably over the five-year statutory payout) and Test 2 (requiring that all investors retain at least 50% of their pro-rata equity interest of the investment) are satisfied. These guidelines are meant to ensure that the investor scrutinizes the merits of the investment in the QHTB and makes an investment for reasons other than for the purpose of receiving tax credits.

II. CERTIFICATION OF CREDIT CLAIMS AND CLAIMS FOR THE INVESTMENT CREDIT

For investments made on or after July 1, 2004, taxpayers[5] must report certain information to the Department <u>before March 30th</u> of each year (following the taxable year in which an investment is made). The Department, in turn, must certify the information, which must be submitted by the taxpayer at the time the investment credit is claimed.

The main purpose of certification is to gather information, and thus, the Department will not examine high credit ratios at the time that the investor applies for certification of credit claims. Instead, an investor with a credit ratio higher than 2:1 (or other transactions that do not fall into the

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[5] For situations in which an investor authorizes either the QHTB or the pass-through entity in which the investor has indirectly invested in a QHTB via the pass-through entity, the Department will administratively allow either the QHTB or the pass-through entity to complete, sign, and file Form N-318A on behalf of the investor provided that the QHTB or pass-through entity has signed authorization from the investor at the time of filing Form N-318A and such filing is submitted before the March 30th due date.

safe harbors described herein and for which the investors have not obtained a favorable ruling from the Department) may claim the credit if the investor has a reasonable basis[6] for asserting that economic substance and business purpose exist for such credit ratio. However, the investor must substantiate economic substance and business purpose at the time the investor actually files a claim for the credit (*i.e.*, at the time the tax return is filed) by attaching an explanation to their N-318.[7] The Department will return the Form N-318A with the notation, "N/A," not applicable.

III. CONCLUSION & EFFECTIVE DATE

The Department of Taxation intends these guidelines to serve as bright-line thresholds to promote certainty and predictability for QHTBs and their investors, as well as to ease administration for the Department. The policy articulated in this TIR will only apply in cases where the representations described herein can be factually established by a taxpayer.

For more information on this Tax Information Release, please contact the Rules Officer, Johnnel Nakamura, at (808) 587-1553.

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Director of Taxation

HRS Explained: 235-110.9

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[6] Note that while an investor/taxpayer may take a tax return position for which there is a reasonable basis, a tax advisor can only advise a taxpayer to take a position for which there is a realistic possibility of its being sustained on its merits. *See § 10.34, Treas. Reg. (31 C.F.R.).*

[7] For more information on the certification process, *see* Form N-318 Ins.; *see also* Department of Taxation Announcement 2003-01.