LINDA LINGLE
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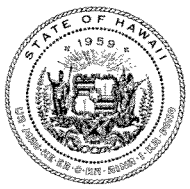

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PHONE NO: (808) 587-5334
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June 29, 2009

[redacted text]

Re: Application of certain tax incentives regarding [redacted text]

Dear [redacted text]:

This letter responds to your request of March 9, 2009 for a comfort ruling confirming that certain tax incentives are available if [redacted text] (the "Company") meets the definition of a qualified high technology business ("QHTB").

In general, Hawaii offers the following tax incentives to qualifying businesses:

1. The high technology business investment tax credit under § 235-110.9, Hawaii Revised Statutes ("HRS");

2. The income tax exclusion for royalties and other income derived from patents, copyrights, and trade secrets received by an individual or a QHTB and developed and arising out of a QHTB under § 235-7.3, HRS;

3. The income tax exclusion for stock options, dividends from stock, the receipt of the options, the exercise of the options, and income from the sale of the options under § 235-9.5, HRS; and

4. The tax credit for research activities under § 235-110.91, HRS.

In addition, other tax provisions may provide tax incentives to a QHTB that do not depend on whether the business meets the definition of a qualified high technology business.

SHORT ANSWER

Based on the information in your request for a high tech comfort ruling, the questionnaire, "Does a Company Qualify for Hawaii Tax Incentives?" ("Questionnaire"), and the representations made by the Company as stated below in this letter (the "Representations"), the Company will meet the definition of a qualified high technology business as defined in both § 235-7.3, HRS and § 235-110.9, HRS, provided the amount of cash invested in the Company does not exceed $ 2,000,000.

Based solely on the Representations, the Company qualifies as a QHTB for purposes of the tax benefits identified above in Paragraph 1.

Based solely on the Representations, the patents, copyrights, or trade secrets developed and arising out of the Company will qualify for the tax benefits identified above in Paragraph 2.

Based solely on the Representations, income earned and proceeds derived from stock options, stock, options to acquire equity interests, or equity interests in the Company will qualify for the tax benefits identified above in Paragraph 3.

The Company also qualifies for other miscellaneous income tax and general excise tax provisions.

FACTS REPRESENTED BY THE COMPANY

The Company makes the following representations:

[redacted text] is a [redacted text] corporation organized on [redacted text], with principal offices located in [redacted text], Hawaii. The Company is a computer software development and design company with two patentable core enabling technologies focusing on the niche social network market. [redacted text]. The Company provides a rich and flexible model that allows businesses to tailor social networks to their particular needs without having to build the system from scratch, or host the infrastructure and maintain the codebase of a turnkey shrink-wrapped solution. The Company also provides network creators with the tools to monetize their network via monthly subscription fees and integrated e-commerce functionality.

The Company is involved in all aspects of software development, including without limitation software engineering, system configuration and security, programming and coding, documentation and technical writing, applications research and testing, and widget interface development. The result is technology that is cutting edge with robust functionality and graphics. [redacted text].

[redacted text]

The Company is considering future versions of its technology, which may include mobile applications [redacted text], s-commerce [redacted text], and lightweight flash virtual world [redacted text].

The Company is currently conducting research and product development activities at its office facilities in [redacted text], Hawaii. The Company will continue to maintain its headquarters, along with its research and development functions in Hawaii. In order to build a viable technology industry in Hawaii and to fully qualify for applicable State tax incentives, the Company is committed to establishing a long-term presence in the State and to utilizing Hawaii goods, services and personnel to the greatest extent possible.

The Company represents that it will have substantial control and retain substantial rights to any intellectual property resulting from its research and development activities relating to its technology.

The Company has made additional representations, in Exhibit A, regarding jobs, Hawaii costs, tax incentives that may be claimed by the Company or its investors, long-term business plans and investments. The information on Exhibit A is an estimate of anticipated production, jobs and compensation. The Company does not warrant or represent that these estimates will be realized, but understands and agrees that if the Company ceases to engage in its qualified research activities as an activity comprising at least 50% of its activities, with at least 75% of such qualified research occurring in Hawaii, within the definitions of §235-110.9, HRS that the Company will cease to qualify as a QHTB and its investors may be required to recapture credits previously taken.

LAW AND ANALYSIS

The requirements for these tax incentives and their application to the Company and related taxpayers are discussed below.

I. High technology business investment tax credit

For investments made in taxable years beginning after December 31, 2000, but before taxable years beginning after December 31, 2010, a nonrefundable high technology business investment tax credit of up to $2,000,000 per taxpayer is available.[1] The credit is graduated over five years (35% to 10%) from the date of the "investment"[2] in a QHTB for investments made in tax years 2001 to 2010.[3] The credit is capped at varying amounts ($700,000 in the year the investment is made to $200,000 in the last year).

The legislature has recently passed Senate Bill 199 which is currently awaiting the approval of the governor. Should this measure become law, credits generated by investments received on or after May 1, 2009 and on or before December 31, 2010 are subject to additional restrictions. These include:

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[1] Taxpayers may continue to claim the credit in taxable years beginning after December 31, 2010 if the five-year period to claim the credit commences in taxable years beginning before January 1, 2011.

[2] "Investment" is defined as "a nonrefundable investment, at risk, as that term is used in section 465 (with respect to deductions limited to amount at risk) of the Internal Revenue Code, in a qualified high technology business, of cash that is transferred to the qualified high technology business, the transfer of which is in connection with a transaction in exchange for stock, interests in partnerships, joint ventures, or other entities, licenses (exclusive or nonexclusive), rights to use technology, marketing rights, warrants, options, or any items similar to those included in this definition, including but not limited to options or rights to acquire any of the items included in this definition. The nonrefundable investment is entirely at risk of loss where repayment depends upon the success of the qualified high technology business. If the money invested is to be repaid to the taxpayer, no repayment except for dividends or interest shall be made for at least one year from the date the investment is made. The annual amount of any dividend and interest payment to the taxpayer shall not exceed twelve per cent of the amount of the investment." See § 235-1, HRS.

[3] Taxpayers may continue to claim the credit if the five-year period to claim the credit commences in taxable years beginning before January 1, 2011.

- Not more than 80% of a taxpayer's tax liability may be offset by utilizing such credits for tax years ending on or before December 31, 2010;

- The credit must be taken ratably over the five year period in accordance with §235-110.9(a), HRS and may not exceed an investment tax credit allocation ratio of 1:1; and

- No carryover of any unused credits from investments made on or after May 1, 2009 for tax years ending on or before December 31, 2010.

Some of the credit claimed will be recaptured from the investor if at the close of any taxable year in the five-year period: (1) the Company no longer qualifies as a QHTB, (2) the Company or an interest in the Company is sold by the taxpayer investing in the QHTB, or (3) the taxpayer withdraws the taxpayer's investment wholly or partially from the QHTB.

The recapture will be equal to ten percent of the amount of the total tax credit claimed for the investment in the two taxable years prior to the year in which any of the aforementioned events occurs. The recaptured amount must be added to the investor's tax liability for the taxable year in which the recapture occurs.

If a QHTB accepts any investments after June 30, 2007, the QHTB is required to file an annual survey as described in Act 206 (Session Laws of Hawaii, 2007). Failure to file the survey when due may result in a penalty of $1,000 per month for each month the annual survey is not filed, not to exceed a total of $6,000 for any annual survey not filed. Furthermore, by accepting an investment for which an investment credit allowed under section 235-110.9, HRS may be claimed, the QHTB is deemed by statute to have consented to the public disclosure of the Company's name and status as a beneficiary of the investment credit.

To be considered a QHTB for purposes of this tax credit, in each of the years for which the credit will be claimed, the Company must employ or own capital or property, or maintain an office, in Hawaii and:

(1) More than 50% of its total business activities must be qualified research and more than 75% of its qualified research must be conducted in Hawaii (the "Activity Test"); or

(2) More than 75% of its gross income must be derived from qualified research and the income from this qualified research must be received from:

(a) Products sold from, manufactured in, or produced in Hawaii; or
(b) Services performed in Hawaii (the "Gross Income Test").[4]

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[4] This definition of a QHTB for purposes of § 235-110.9 differs from the definition of a QHTB in § 235-7.3, HRS, which is discussed in Part II of this letter.

If the Company contracts with another person to perform qualified research, the research will qualify as research performed by the Company for the purpose of determining the Company's status as a QHTB only if the contract meets the following requirements:

(1) The contract must be entered into before the performance of the qualified research activity;

(2) The contract requires the Company to bear the expense of the research even if the project is unsuccessful;

(3) The contract provides that the research is to be performed on behalf of the Company and the Company will have substantial rights to the research results[5]; and

(4) The contract provides that the company performing the research will not claim the Hawaii qualified high technology business investment credit under HRS §235-110.9 or the Hawaii tax credit for research activities under HRS §235-110.91 for the activities performed on behalf of the Company.

If another person contracts with the Company to have the Company perform qualified research, the research will not qualify as research performed by the Company for the purpose of determining the Company's status as a QHTB if the above requirements have been met in favor of the other person, even if the other person is not a QHTB.

The Department has also released Tax Information Release 2008-07 (High Tech Comfort Rulings Relying Upon the Gross Income Test), which is incorporated by reference herein.

A. The Company's presence in Hawaii

The Company, a corporation, represents that it maintains its office in Hawaii.

B. The Company's qualified research activities

The term "qualified research" means:[6]

(1) The same as in § 41(d), Internal Revenue Code ("IRC");
(2) The development and design of certain computer software;
(3) Biotechnology;

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[5] If the Company receives a license, the term of the license must be for the useful life of product(s) or research.

[6] Section 235-110.9, HRS, incorporates the definition of "qualified research" in § 235-7.3, HRS.

(4) Performing arts products;
(5) Sensor and optic technologies;
(6) Ocean sciences;
(7) Astronomy; or
(8) Nonfossil fuel energy-related technology.

Item (2) The development and design of certain computer software

To meet the requirements of Item 2, the Company must develop and design computer software[7] for ultimate commercial sale, lease, license, or to be otherwise marketed, for economic consideration. With respect to the software's development and design, the Company must have substantial control and retain substantial rights to the resulting intellectual property.

In Part I of the Questionnaire, the Company checked the box indicating that it develops and designs computer software. By checking this box, the Company represents that the computer software is for ultimate sale, lease, license or otherwise marketed for economic consideration and the Company has substantial control and retains substantial rights to the resulting intellectual property.

As represented above, the Company is a computer software development and design company with two patentable core enabling technologies focusing on the niche social network market [redacted text] which give businesses the ability to create customized social networks without having to build the system from scratch, or host the infrastructure and maintain the codebase of a turnkey shrink-wrapped solution. The Company is involved in all aspects of software development activities, including without limitation software engineering, system configuration and security, programming and coding, documentation and technical writing, applications research and testing, and widget interface development. [redacted text]. Possible future versions of the Company's technology include mobile applications, s-commerce, and lightweight flash virtual world.

Based solely on the Representations, the Company performs qualified research pursuant to the requirements of Item (2).

C. Activity Test and Gross Income Test

Under § 235-110.9, HRS, in order for a company performing qualified research to meet

[7] "Computer software" is defined as "computer data, a computer program, or a set of computer programs, procedures, or associated documentation concerned with the operation and function of a computer system, and includes both systems and application programs and subdivisions, such as assemblers, compilers, routines, generators, and utility programs." "Computer data" is defined as "any representation of information, knowledge, facts, concepts, or instructions that is being prepared or has been prepared and is intended to be processed, is being processed, or has been processed in a computer or computer network." "Computer program" is defined as "an ordered set of computer data representing coded instructions or statements, that, when executed by a computer, causes the computer to perform one or more computer operations." See § 235-1, HRS.

the definition of a QHTB, it must be a business employing or owning capital or property, or maintaining an office, in the State of Hawaii. In addition, the company must meet the requirements of either the Activity Test or the Gross Income Test. Under the Activity Test, a company is a QHTB if more than 50% of its total business activities are qualified research and more than 75% of such qualified research is conducted in Hawaii. Under the Gross Income Test, a company is a QHTB if more than 75% of its gross income is derived from qualified research in the form of either (i) products sold from, manufactured in, or produced in Hawaii, or (ii) services performed in Hawaii.

Due to the highly fact intensive nature of qualifying as a QHTB under the Gross Income Test, including the uncertainty and ambiguity of: 1) revenue streams associated with qualified research; 2) determining the source of product sales; 3) manufacturing or production quantification; as well as 4) the extent services are performed in the State within the meaning of HRS § 235-110.9(g), the Department will not issue rulings determining whether a business satisfies the Gross Income Test for purposes of qualifying as a QHTB.

The Company represents that it will maintain an office in Hawaii.

The Company represents that it will meet the Activity Test because more than 50% of its activities will be in qualified research and more than 75% of those qualified research activities will be conducted in Hawaii. In making this determination, the Company used a numerator that contained the costs of activities in direct support of qualified research and a denominator that included all costs for all activities.[8] Furthermore, as to the requirement that 75% of the qualified research activities be conducted in Hawaii, the Company used a numerator that contained all costs incurred in direct support of qualified research activities conducted in Hawaii and a denominator that contained all costs incurred for all qualified research activities. In making these representations about the Activity Test, the Company understands that the following activities do not count as qualified research activities for purposes of this test:

- Activities associated with research that is funded by grants and in which the Company has no substantial risks and rights;
- Activities associated with research being performed by the Company pursuant to a contract in which the contract requirements discussed in Part I, above, have been met in favor of another party to the contract; and
- Activities performed by another business on behalf of the Company where the contract requirements discussed in Part I, above, have not been met in favor of the Company.

Based on the Representations, the Company is a QHTB for purposes of the high technology business investment tax credit because it meets the requirements of item (2) in the definition of "qualified research," the Company will maintain an office in Hawaii, and the

[8] "Business activities" may be measured by the cost of these activities, the time spent on these activities, or another consistently applied reasonable basis. This statement is based upon general principles in the income tax and general excise tax law. Whatever the measure adopted by the taxpayer, the measure must reasonably reflect business realities.

Company satisfies the Activity Test. Solely based on the Representations, investments (as defined in HRS § 235-1) in the Company will qualify for the high technology business investment tax credit.

D. Credit Recapture

Section 235-110.9(d), HRS, provides for recapture of credits that have been claimed by a taxpayer where one of the following three events occurs (recapture event):

(1) The business no longer qualifies as a QHTB;
(2) The business or an interest in the business has been sold by the taxpayer investing in the QHTB;
(3) The taxpayer has withdrawn the taxpayer's investment wholly or partially from the QHTB.

Where recapture is triggered, 10% of the amount of the total tax credit claimed by the selling or withdrawing investor in each of the two taxable years prior to the year in which recapture occurs must be added to such investors' tax liability for the taxable year in which the recapture occurs.

The credit cannot be claimed in the year of a recapture event because investors do not have an investment in a QHTB. If a recapture event occurs, the Company should notify the investors that they are not eligible to claim the credit and that some of the credit claimed in prior years shall be recaptured.

E. Credit Allocation

During the 2009 legislative session, both chambers of the state legislature passed Senate Bill 199, a bill which has several consequences with regard to how the high technology business investment tax credit may be allocated among investors in a QHTB.

Credit Allocation Under Current Law

The Department may review any claim for the high technology business investment tax credit for economic substance and business purpose. If an investor is allocated tax credits that exceed twice the amount that that investor invested, indirectly or directly, the investor must substantiate the economic substance and business purpose of the investment and allocation. If an allocation of tax credits is no more than one-and-one-half times the amount invested, then economic merit and business purpose is presumed. These ratios presume that credits are taken ratably in accordance with § 235-110.9(a), HRS.

For allocations of tax credits that do not exceed twice the amount of cash invested, the Department will not require an investor in the Company claiming the credit to substantiate the economic substance and business purpose of the investment provided that the conditions set forth in Tax Information Release 2007-04 are met, i.e., the investor must receive total investment credits ratably in accordance with the 5-year credit schedule (the "No Frontloading of Credits Test") and the investor must retain at least half (50%) of the pro-rata equity interest of the

investment in the QHTB (the "Limited Equity Shifting Test").

Based upon the Representations, specifically the representations that

1. the investment credit ratio will not exceed two dollars in credits per each dollar invested and the investment credit allocation will follow the five-year tax credit schedule, as described in TIR 2007-04, and

2. each investor in the Company will retain at least fifty percent (50%) of the pro-rata equity interest in the Company, as described in TIR 2007-04,

an investor will meet the requirements of both the No Frontloading of Credits Test and the Limited Equity Shifting Test. In light of meeting the requirements of the safe harbor, the Department will not require an investor in the Company to substantiate economic substance and business purpose with respect to this investment transaction. However, if these representations are not met, then the Department will require an investor to substantiate economic substance and business purpose with respect to an investment in the Company.

Credit Allocation if Senate Bill 199 (2009) Becomes Law

Senate Bill 199, should it become law, does not allow the special allocation of the investment tax credit under section 235-110.9 and requires that only $1 of credit be taken for each dollar invested by the taxpayer claiming the credit. Allocation of credits in excess of 1:1 will not be allowed for investments made on or after May 1, 2009.

II. Income tax exclusion for royalties and other income from QHTB

Pursuant to § 235-7.3, HRS, an income tax exclusion is available for income received by an individual or a QHTB[9] as royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of a QHTB.[10] The exclusion may be claimed by the individual or QHTB that owns the patents, copyrights, or trade secrets. For purposes of the royalty income exclusion, a QHTB is defined as "a business conducting more than 50% of its activities in qualified research."[11]

As discussed in Part I, relating to the high technology business investment tax credit, the Company, based on the Representations, meets the requirements of item (2) in the definition of

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[9] If the QHTB receiving the income is treated as a partnership for income tax purposes, then the partners or members of the QHTB may exclude the allocated portion of such income, even if the partner or member excluding the income is not an individual or QHTB.

[10] Expenses for royalties and other income derived from any patents, copyrights, and trade secrets by an individual or a QHTB as defined in § 235-7.3, HRS, are deductible. See § 235-2.4(g), HRS.

[11] This definition differs from the definition of a QHTB in § 235-110.9, HRS, which is discussed in Part I of this letter.

"qualified research." The Company also represents that more than 50% of the Company's activities are in qualified research, again using a numerator that contained the costs of qualified research activities and a denominator that included all costs for all activities. Based on the Representations, royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of the Company received by an individual[12] or a QHTB may be excluded from income tax. Furthermore, as long as the Company is a QHTB for purposes of § 235-7.3, HRS and treated as a partnership for income tax purposes, each member's allocated portion of royalties and other income derived from patents, copyrights, and trade secrets owned by the Company and developed and arising out of a QHTB may be excluded from income tax by the members of the Company.

III. Income tax exclusion for stock options from qualified high technology business

Section 235-9.5, HRS, provides an exclusion for "all income earned and proceeds derived from stock options or stock," including stock issued through the exercise of stock options or warrants, from a QHTB or from a holding company of a QHTB[13] by an employee, officer, or director of the QHTB, or investor who qualifies for the high technology business investment tax credit in § 235-110.9, HRS, effective for taxable years beginning after December 31, 2000. This exclusion is applicable to dividends from stock or stock received through the exercise of stock options or warrants, the receipt or the exercise of stock options or warrants, and income from the sale of stock, including stock issued through the exercise of stock options or warrants.[14]

With respect to a partnership or a limited liability company treated as a partnership for income tax purposes, the exclusion is applicable only to the gain from the sale of membership interest units. For purposes of this income tax exclusion, a QHTB means the same as defined in §235-7.3, HRS, relating to the income tax exclusion for royalties.

As discussed in Part I, relating to the high technology business investment tax credit, the Company, based on the Representations, meets the requirements of item (2) in the definition of "qualified research." The Company also represents that more than 50% of the Company's activities are in qualified research, again using a numerator that contained the costs of qualified research activities and a denominator that included all costs for all activities. Based on the Representations and assuming the Company is treated as a corporation for income tax purposes,

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[12] The performing arts product exclusion in § 235-7.3, HRS, is applicable to the author and assignors, licensors, and licensees.

[13] A holding company of a QHTB means any business entity that possesses:

(1) At least eighty per cent of the total voting power of the stock or other interest; and

(2) At least eighty per cent of the total value of the stock or other interest in the qualified high technology business.

[14] Section 165, IRC, is operative for Hawaii income tax purposes and applies to losses sustained from the sale of stock issued through stock options or warrants granted by a QHTB. See § 235-2.4(d), HRS.

the income earned and proceeds derived from stock options, stock, options to acquire an equity interest, or equity interests may be excluded from income tax.

IV. Miscellaneous Provisions

Section 235-2.45(e), HRS allows a corporate QHTB, as defined in §235-7.3, HRS, to carry forward capital losses for 15 years. Provided that Company is taxed as a corporation for income tax purposes, the Company may qualify for this provision.

The law provides additional tax incentives which are not dependent on the Company qualifying as a QHTB.

- **Technology infrastructure renovation tax credit.** A nonrefundable income tax credit of 4% of the "renovation costs" for each commercial building located in Hawaii is available for tax years 2001 through 2010.[15] "Renovation costs" means costs incurred after December 31, 2000, to plan, design, install, construct, and purchase technology-enabled infrastructure equipment to provide a commercial building with technology-enabled infrastructure. A taxpayer that claims a technology infrastructure renovation tax credit cannot claim any other credit under Chapter 235.

- **Expanded related entities exemption**. The related entities exemption which exempts from the general excise tax (GET) amounts received, charged, or attributable for "services" or interest between one "related entity" and another "related entity" is expanded. The use of computer software and hardware, information technology services, and database management between related entities is exempt from the GET. These changes are applicable to gross income or gross proceeds received beginning July 1, 2001.

- **Capital goods excise tax credit**. §235-110.7, HRS, provides for a capital goods excise tax credit deductible from net income tax liability in the taxable year in which the credit is claimed. If the capital goods excise tax credit exceeds the taxpayer's net income tax liability, the excess of credit over liability is refundable for amounts greater than $1. After December 31, 2002, generally the tax credit amount equals 4% of the cost of the "eligible depreciable tangible personal property" used in a trade or business and "placed in service", as such terms are defined in §235-110.7, HRS. In the case of "eligible depreciable tangible personal property" for which a credit for sales or use taxes paid to another state is allowed under §238-3(i), the tax credit amount shall not exceed the use tax amount.

Note that Senate Bill 199 (2009), if it becomes law, temporarily suspends the capital

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[15] Act 215 SLH 2004 extended the sunset date for the technology infrastructure renovation credit to December 31, 2010.

goods excise tax credit for the 2009 tax year.

V. Conclusion

Based solely on the Representations, the Company qualifies for:

1. The high technology business investment tax credit under §235-110.9, HRS, subject to any changes mandated by Senate Bill 199 should the measure become law;

2. The income tax exclusion for royalties and other income derived from patents, copyrights, and trade secrets received by an individual or a QHTB and developed and arising out of a QHTB under §235-7.3, HRS;

3. If the Company is taxed as a corporation, the income tax exclusion for income earned and proceeds derived from stock options or stock, including income from dividends from stock or stock received through the exercise of stock options or warrants, the receipt or exercise of stock options or warrants, and the sale of stock options or stock, including stock issued through the exercise of stock options or warrants, under §235-9.5, HRS is applicable. If the Company is treated as a partnership for income tax purposes, the section 235-9.5, HRS exclusion is applicable only to the gain from the sale of membership units;

4. Other miscellaneous tax provisions.

This ruling is applicable only to the Company and shall not be applied retroactively. It may not be used or cited as precedent by any other taxpayer, and is based on our understanding of the facts that you have represented and only apply if the amount of cash investments received by the Company does not exceed $ 2,000,000. In the event that the Company finds it necessary to increase the amount of investment monies to be obtained which qualifies for the high technology business investment tax credit, the Company shall submit a supplemental ruling request to the Department. No user fee shall be assessed on such supplemental ruling request. If it is later determined that our understanding of these facts is not correct, the facts are incomplete, or the facts later change in any material respect, the conclusion in this letter will be modified accordingly. This ruling also may be subject to change due to future amendments to laws, rules, or official Department positions.

If you have any further questions regarding this matter, please call me at 808-587-5334. Additional information on Hawaii's taxes is available at the Department's website at **http://www.hawaii.gov/tax**.

Sincerely,

Jacob L. Herlitz
Administrative Rules Specialist

[redacted text]