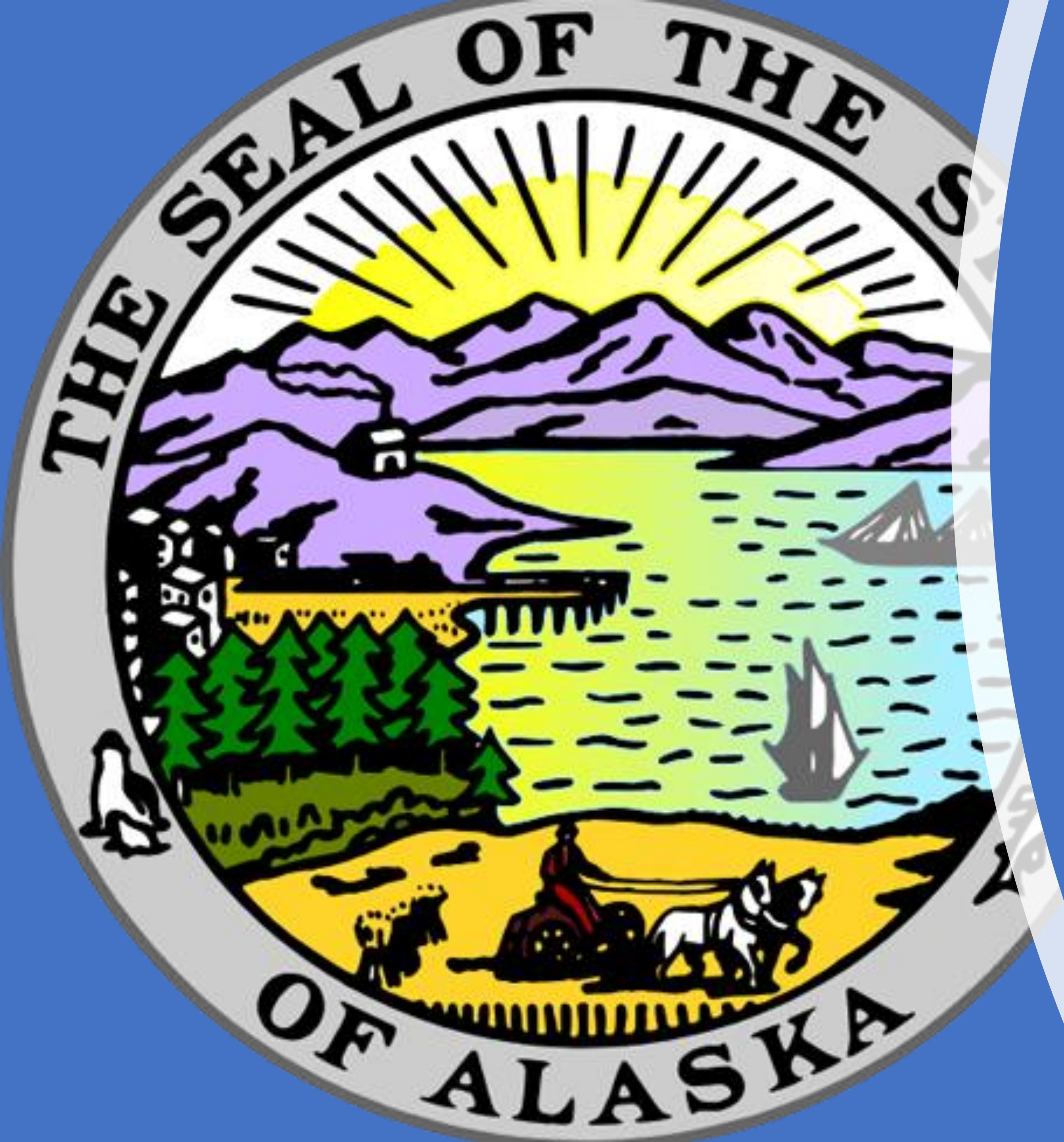


SB 113

Corporate Income Tax Modernization

Senate Rules Committee
Senator Bill Wielechowski, Chair

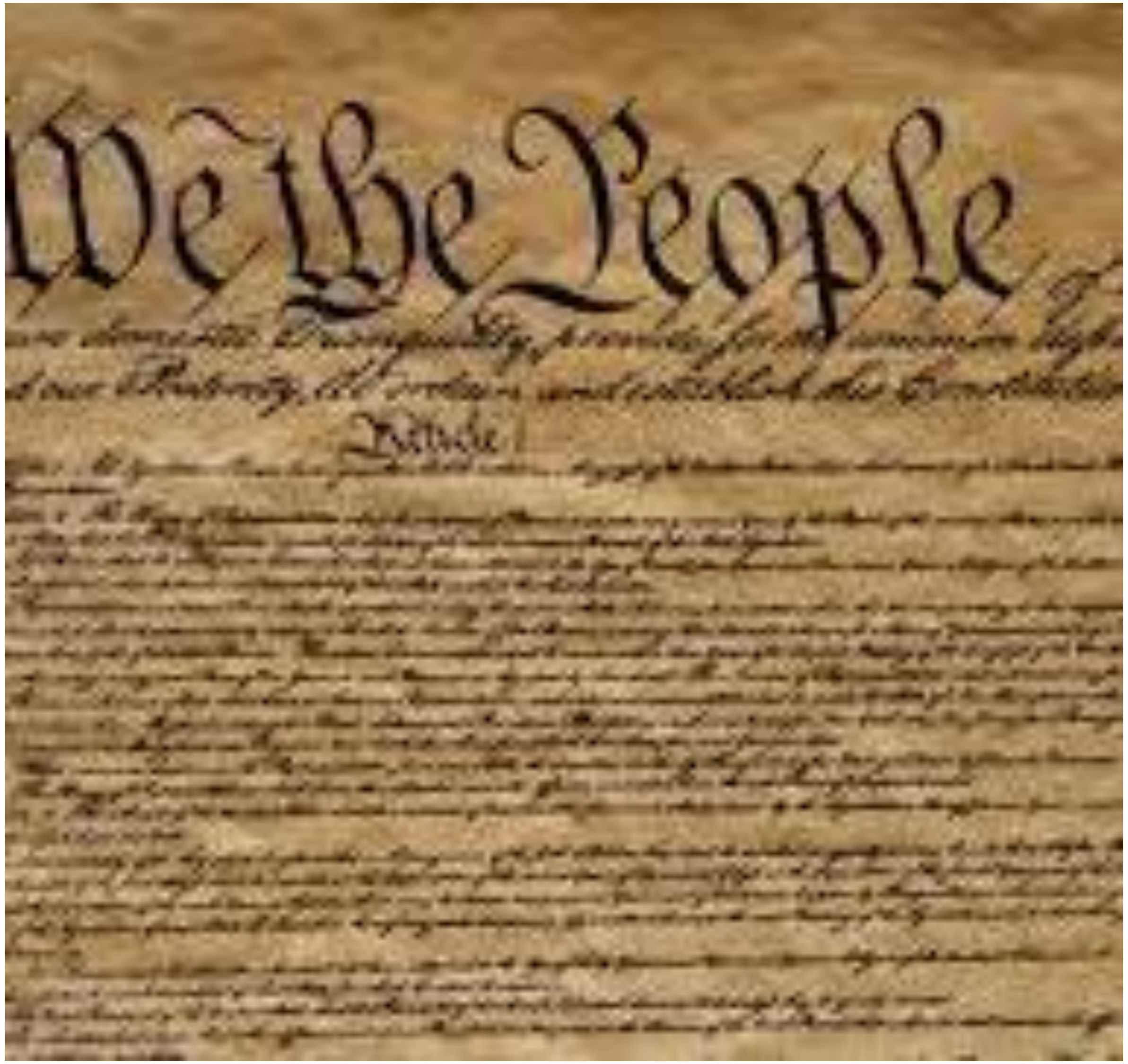
SB 113 makes two reforms to bring Alaska's tax apportionment system into the 21st century

Market-based sourcing to ensure Alaskan sales are properly apportioned to the state

Single sales factor for highly digitized businesses

SB 113 makes no changes to corporate income tax rates or brackets.

What is tax apportionment?



Under the Commerce Clause of the U.S. Constitution, states may only tax activity that is reasonably attributable to that state.

For taxpayers who operate in multiple states, it is necessary to determine what portion of their income can be taxed by each state.

To avoid taxpayers having to do separate accounting in each state, states have adopted mathematical formulas to determine tax apportionment.

The U.S. Supreme Court has ruled that states must use "fair apportionment" to determine what is taxable by their state, requiring the system be internally and externally consistent.

<u>Internal consistency:</u>

If all states used the same system, there would be no double taxation.

<u>External consistency:</u>

That the value taxed is "fairly attributable" to the state.

Oklahoma Tax Comm'n v. Jefferson Lines, Inc., 514 U.S. 175 (1995)

Traditionally states have used an equally weighted three-factor formula for tax apportionment

Sales Factor

The percentage of a taxpayer's sales that are made in the state

Property Factor

The percentage of a taxpayer's property that is located in the state

Payroll Factor

The percentage of a taxpayer's payroll that is made in the state

The Traditional Three-Factor Corporate Tax Apportionment Formula

$$\text{Share of Total Corporate Income Apportioned} = \left[\frac{\dfrac{\text{Statewide Property}}{\text{Total Property}} + \dfrac{\text{Statewide Sales}}{\text{Total Sales}} + \dfrac{\text{Statewide Payroll}}{\text{Total Payroll}}}{3} \right] \times \text{Total Income}$$

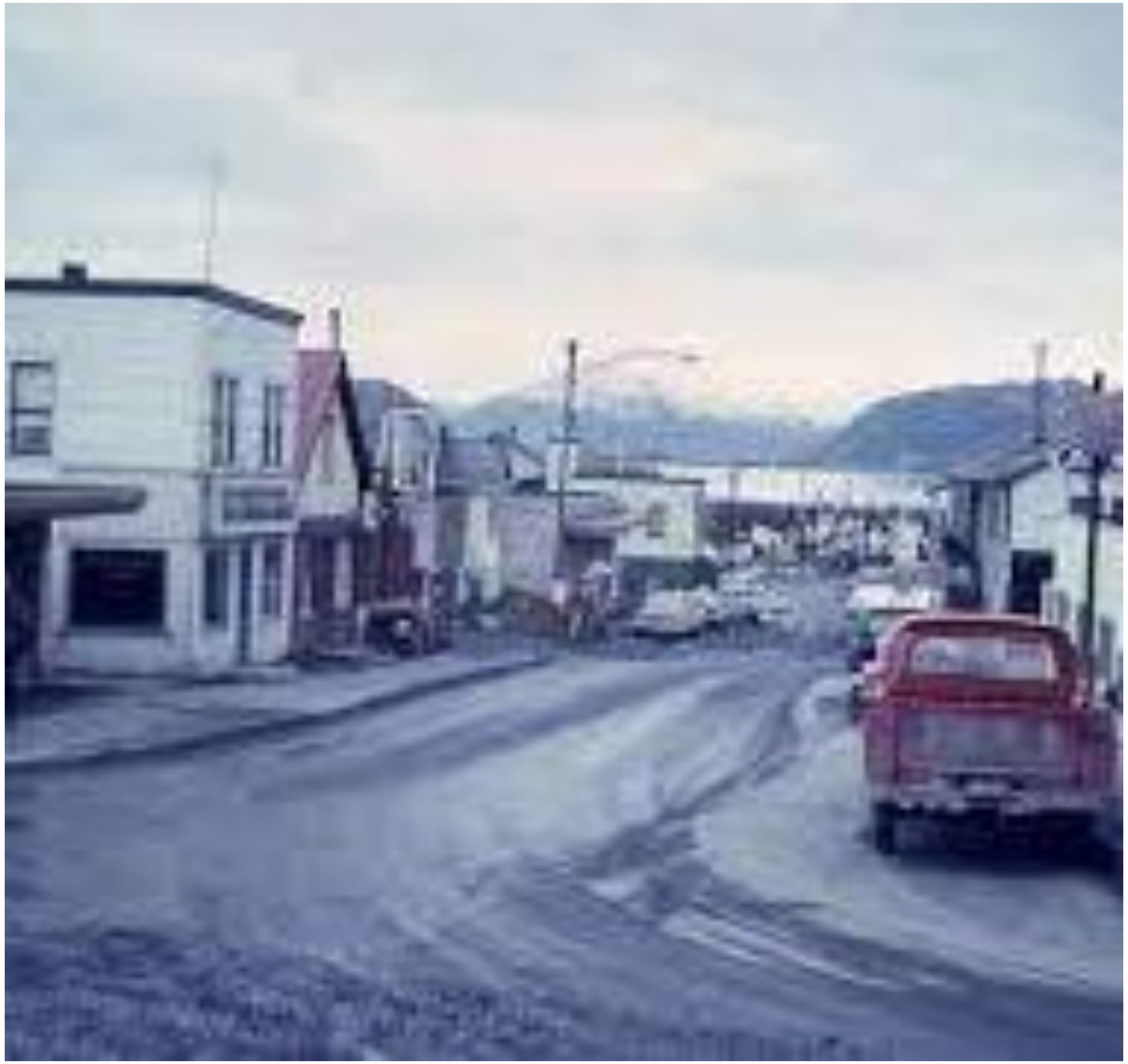
Alaska is a member of the Multistate Tax Compact

This is an advisory compact with 14 other states and the District of Columbia that promotes uniformity in tax apportionment and filing procedures.

The Commissioner of Revenue represents Alaska on the commission that governs the compact.

The 6th Alaska State Legislature codified the compact in Alaska Statutes in 1970 as AS 43.19.010 which establishes Alaska's tax apportionment laws.

The Legislature has not made any amendments to this statutory language since then.



The current apportionment formula was designed for a brick-and-mortar world

In the modern digital economy a corporation can target advertising to Alaska, sell a product through Alaska's broadband infrastructure, and ship it through Alaska's roads, ports and airports without having any property or payroll in Alaska.

SB 113 makes common sense reforms to ensure these sales are properly apportioned to Alaska.

Market-Based Sourcing

Currently Alaska uses a methodology called “cost of performance” to determine whether sales happened in Alaska

- Under cost of performance, a sale is considered to happen in Alaska when “the income producing activity is performed in this state.”
- This means that out-of-state corporations can argue that online sales to Alaskans do not take place in Alaska.

SB 113 replaces cost of performance with a “market-based” methodology where sales will be considered to happen in Alaska when the market for the sales is in Alaska.

Under market-based sourcing a sale occurs in Alaska when:

- For sales of real property, when the property is located in the state
- For tangible personal property, when the property is located in the state
- For services, when the service is delivered in the state
- For intangible property, when it is used in the state

At least 36 other states already use some form of market-based sourcing

- Alabama
- Arizona
- California
- Colorado
- Connecticut
- Georgia
- Hawaii
- Idaho
- Illinois
- Indiana
- Iowa
- Kentucky
- Louisiana
- Maine
- Maryland
- Massachusetts
- Michigan
- Minnesota
- Missouri
- Montana
- Nebraska
- New Hampshire
- New Jersey
- New Mexico
- New York
- North Carolina
- Ohio
- Oklahoma
- Oregon
- Pennsylvania
- Rhode Island
- Tennessee
- Utah
- Vermont
- West Virginia
- Wisconsin

Source: Wolters Kluwer CCH AnswersConnect State Tax SmartCharts

Single Sales Factor for Highly Digitized Businesses

For highly digitized businesses only, the sales factor would be the only factor used for tax apportionment.

$$\text{Share of Total Corporate Income Apportioned} = \left[\frac{\text{Statewide Sales}}{\text{Total Sales}}\right] \times \text{Total Income}$$

A business would be considered highly digitized if 50% or more of its Alaska sales are of:

- Intangible property delivered electronically
- Services delivered electronically
- Services related to computers, electronic transmission, or internet technology
- Tangible property purchased through the internet

The three-factor formula will still be used for brick-and-mortar businesses

$$\text{Share of Total Corporate Income Apportioned} = \left[\frac{\dfrac{\text{Statewide Property}}{\text{Total Property}} + \dfrac{\text{Statewide Sales}}{\text{Total Sales}} + \dfrac{\text{Statewide Payroll}}{\text{Total Payroll}}}{3} \right] \times \text{Total Income}$$

Alaska has previously adopted a different apportionment formula for the oil and gas industry, because the Legislature found that the traditional formula did not fairly reflect their Alaska income.

Similarly, it is appropriate to use a different formula for highly digitized businesses, because the current formula does not fairly reflect Alaska sales.

The current three-factor formula is a disincentive to high-tech businesses opening Alaska facilities

Having payroll and property in Alaska can significantly increase an online business' Alaska taxes.

Adopting a single sales factor for this industry will remove this disincentive and level the playing field between out-of-state and Alaska businesses.

At least 37 other states already use a single sales factor for at least some industries

- Alabama
- Arizona
- Arkansas
- California
- Colorado
- Connecticut
- Delaware
- Florida
- Georgia
- Idaho
- Illinois
- Indiana
- Iowa
- Kentucky
- Louisiana
- Maine
- Maryland
- Michigan
- Minnesota
- Mississippi
- Missouri
- Montana
- Nebraska
- New Hampshire
- New Jersey
- New Mexico
- New York
- North Carolina
- North Dakota
- Oregon
- Pennsylvania
- Rhode Island
- South Carolina
- Utah
- Vermont
- West Virginia
- Wisconsin

Source: Wolters Kluwer CCH AnswersConnect State Tax SmartCharts

These reforms would have little or no impact on Alaskan consumers

Online businesses generally set their prices at the national or global level

Both market-based sourcing and single sales factor are common features of tax apportionment systems across the country

This bill does not change the tax rates or brackets at all, merely the formula for determining what income is taxable in Alaska.

Questions?

Senator Bill Wielechowski
(907) 465-2435
Sen.Bill.Wielechowski@akleg.gov

David Dunsmore
(907) 465-8164
David.Dunsmore@akleg.gov