

Testimony before the Alaska House Labor & Commerce Committee On House Bill 36

Matthew Gardner
Institute on Taxation and Economic Policy

April 1, 2017

Thank you for the opportunity to testify on the changes House Bill 36 would make to Alaska's tax treatment of pass-through income. The taxation of pass-through business entities has been a focal point of state and federal tax reform debates for over a quarter century, with a dual focus on minimizing the role of tax laws in determining the choice of business entity and on ensuring that the income of all business entities is subject to at least a minimal tax. My testimony makes two main points:

1. Alaska is one of a small number of states that do not currently impose either an entity-level tax or a personal income tax on the income generated by pass-through businesses. But Alaska fully taxes the income of traditional C corporations, creating a clear incentive for businesses to structure as pass-throughs to avoid income tax.
2. In the absence of a statewide personal income tax, imposing an entity-level tax on the net income of pass-through businesses, as HB36 would do, is a straightforward approach to leveling the playing field between different types of business entities, while ensuring these businesses help to fund public investments.

Current Approaches to Taxing Pass-Through Income

Under federal income tax rules, the income of corporations is generally subject to the corporate income tax. Exceptions are made for sole proprietorships, partnerships, S corporations and limited liability companies. These companies are known as "pass-through" entities because their income is taxed directly to the individual owners of the companies, and the companies themselves are not subject to an entity-level federal income tax.

Forty-two states and the District of Columbia levy broad-based personal income taxes, and almost all of these jurisdictions mirror the federal income tax treatment of pass-through entities. That is, owners of pass-through entities in these states typically include their income from these entities in their gross income subject to personal income taxes, and apply the same marginal tax rates to pass-through income that are applicable to salaries, wages, and other forms of personal income.

Four personal-income-tax states have enacted special tax rules that treat pass-through income differently from other forms of personal income. Most notably (and most controversially), Kansas completely excludes pass-through income from its personal income tax (although the wages paid by pass-through businesses are still subject to the state's personal income tax.) Ohio excludes the first \$250,000 of pass-through income from the personal income tax, while fully taxing wages associated with pass-through businesses. Oregon applies the same top tax rate to pass-through and other forms of income, but uses much wider tax brackets for active pass-through income, with the 9.9 percent top rate

only applying over \$5,000,000. South Carolina applies a flat tax rate of 3 percent to certain income of pass-through businesses, while taxing other income (including wages associated with pass-throughs) at a top rate of 7 percent.

Nine states do not levy a broad-based tax on personal income, creating at least the potential for a substantial inequity between the tax treatment of the income of C corporations and the treatment of pass-through businesses. These states are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming. The nine non-income tax states have taken a variety of approaches to taxing pass-through entities' income:

- Include some pass-through income in corporate income tax base (New Hampshire, Tennessee)
- Impose gross receipts tax on revenues of pass-through (and other) business entities (Nevada, Texas, Washington)
- Exempt all income of pass-through entities (Alaska, Florida, South Dakota, Wyoming)

Alaska is one of four states that generally exempt all income of pass-through entities from tax. But two of these states (South Dakota and Wyoming) don't impose any entity level income tax on traditional C corporations. Only Alaska and Florida fully tax C corporations while fully exempting the income of pass-through businesses.

It is impossible to measure the extent to which the potential state tax reductions associated with pass-through status have encouraged business owners to incorporate as pass-throughs rather than C corporations. State taxes are only one factor driving this decision; other factors, including the regulatory and legal structure governing each form of entity as well as the much higher federal tax rates facing business income both on the personal and corporate tax side, likely play as important a role. Yet it has been widely acknowledged for decades that, absent other constraints, business owners can zero out their Alaska income tax liability simply by organizing as a pass-through rather than a C corporation. As early as 1998, Alaska Deputy Revenue Commissioner Deborah Vogt observed that "[i]n a place that doesn't have a state income tax you'd be an idiot to start up a C corporation."

To the extent business leaders have taken Commissioner Vogt's advice in the last two decades, the most obvious effect on Alaska's economy has been a gradual drain on the yield and fairness of the state's corporate income tax. Tax fairness is an important goal, in part, because obvious violations of the tax fairness principle reduce the public's confidence in the workings of the tax system, in the state government officials who administer the tax system, and the state legislators who are charged with maintaining a modern and effective set of tax laws. And in a fiscally challenging environment, the revenue losses associated with any form of tax avoidance must be made up by higher taxes on the rest of us. But the gap between the tax treatment of pass-throughs and C corporations also threatens the long-term economic growth of the state of Alaska.

Among the basic principles of a sound tax reform is "tax neutrality," which is achieved when individuals and businesses make their investment and other fiscal decisions based on their economic merits, rather than making these decisions for tax reasons. For anyone seeking to maximize state economic job, neutrality should be an important goal: after all, when companies make investments based on tax rules rather than basing their decisions on market forces, they are by definition making investments that are inefficient. While a neutral tax system is virtually impossible to accomplish in the real world, policymakers can take important steps toward this goal by avoiding fiscal policies that provide strong incentives for businesses to act in a certain way for reasons that have little or no economic substance other than tax savings. The substantial difference between Alaska's 9.4 percent top corporate income tax rate and the 0 percent rate available to companies that restructure as non-C corporations appears to be a clear example in which equalizing these two tax rates might achieve efficiency gains for the Alaska economy.

Impact of House Bill 36

House Bill 36 would take a step toward equalizing the Alaska income tax treatment of C corporations and pass-through entities, by imposing an entity level tax on the income of sole proprietorships, partnerships, limited liability corporations and S corporations. The bill would impose a graduated tax, with a zero tax rate on the first \$250,000 of taxable income for each entity, and tax rates gradually increasing to 9.4 percent on taxable income exceeding \$1 million. By comparison, traditional C corporations pay a zero percent tax rate only on the first \$25,000 of taxable

income, and pay the 9.4 percent marginal tax rate on taxable income exceeding \$222,000. By these measures, the proposed tax brackets for pass-through businesses would likely exempt proportionally more businesses from tax than the brackets applicable to C corporations, and would likely result in lower effective tax rates across the board on pass-through businesses than those facing C corporations.

By equalizing the top marginal rate on pass-through and C corporations, HB 36 would dramatically reduce the incentive for new Alaska businesses to choose their form of entity, and for existing businesses to restructure their legal form, for no reason other than tax avoidance. The bill would also raise needed revenues to help balance the state's budget going forward. And, importantly, the bill would end a clear inequity in the tax system that allows adept tax planners to pay far less taxes than equally situated competitors that have not reorganized for tax purposes.

Thank you for the opportunity to testify.

Laura Chartier

From: Barbara McDaniel [REDACTED]
Sent: Saturday, April 01, 2017 4:15 PM
To: Laura Chartier
Subject: Testimony/comment on HB35

Good Afternoon member of the House Labor and Commerce Committee.

I am writing in support of HB35 and urge the committee members to pass it out of committee. We know Alaska is in a recession and must continue our recovery work through added austerity measures over the next, hopefully, few years. All Alaskan residents and nonresidents doing business in Alaska must chip in and absorb their share of the sacrifices needed for a successful and a quicker recovery.

Alaskans have significantly sacrificed through reduced or eliminated state public services and by having their permanent fund payouts cut in half. Of course those sacrifices were greater burdens for hard-working, low and middle-income Alaskans than for those hard-working Alaskans with the highest incomes. So we also need some taxes.

HB35 addresses the injustice of an exemption for Alaska corporations that earn over \$200,000 from paying Alaska's corporate tax via a loophole. HB35's provision to eliminate the loophole is clearly the right thing to do. I don't accept the idea that, inevitably, "Life isn't fair." I've always responded, "Humans make up their own rules; so we can make up fair rules." HB35 is an act of fairness. Please pass it.

Barbara McDaniel

1040 N Craig Stadler Loop

Wasilla, AK 99623

907-373-6977

Laura Chartier

From: Mo Hillstrand [REDACTED]
Sent: Saturday, April 01, 2017 1:47 PM
To: Laura Chartier
Subject: TAX ME PLEASE-SMALL BUSINESS OWNER-LIFELONG ALASKAN

Good afternoon,

I'm writing in support of HB 36 removing the tax exemption for high-profit businesses.

I am an Alaskan small business owner in the medical sector and I believe it is in all of our best interest to share the responsibility for the cost of government. Shortsighted individuals may see this as a burden but in the long-term a stable tax matrix including individuals and businesses will provide a more stable and sustainable long-term solution.

On review of Charisse Mallet's note on this bill and discounting income tax in general, I see a short sighted undermining of individual and business participation in government.

Dependence on oil/gas income and recalculation of the PFD are archaic approaches to this problem and will leave us in a "boom and bust" mentality which got us into this problem in the first place.

Please call me if you have any questions.

Warm regards

Mo Hillstrand

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Laura Chartier

From: Mike Fenster & Jeanne Meinert
Sent: Sunday, April 02, 2017 10:30 PM
To: Rep. Chuck Kopp
Cc: Laura Chartier
Subject: Support HB 36

Representative Kopp,

Please join me in supporting HB 36. In this time of economic hardship, it is past sue that all corporations play by the same rules in Alaska. No more loopholes for special types. I cannot think of a single more important piece of legislation to support. Thanks.

Peace,
Mike

Michale Fenster
12448 Chokecherry Circle
Anchorage, AK 99515

Laura Chartier

From: Cindi Lagoudakis [REDACTED]
Sent: Saturday, April 01, 2017 1:06 PM
To: Laura Chartier
Subject: Comments in favor of HB 36

I have read the text of HB 36 and SSHB 36, and am in support of this bill. Alaska's current fiscal crisis demands an "all hands" approach to solving our budget crisis. Many of the fiscal remedies proposed thus far disproportionately affect the middle and lower income residents of this state. Corporations conducting business in Alaska can and should contribute to investments in the State's infrastructure, education, health, safety, economic climate, future and general quality of life.

Thank you for the opportunity to comment.

Cynthia Lagoudakis
Petersburg, AK

Laura Chartier

From: Mary Ver Hoef [REDACTED]
Sent: Friday, March 31, 2017 8:57 PM
To: Laura Chartier
Subject: I support HB 36

Hello Labor and Commerce Committee (and all Alaska House Representatives):

I am writing to tell you that I support HB 36, and ask you to do the same.

We ALL need to work together and pay our fair share of taxes - especially high profit businesses and corporations. Small local businesses, those that make less than \$200,000 profits are OK to keep exempt from taxes for now, but larger earners should not skip by tax-free while low income Alaskans forgo portions of their PFD and pay personal income tax. Larger businesses, S-corps and other non C-Corporations should be taxed, perhaps on a grading scale so those with larger profits pay an equal or higher percentage. The current "tax exempt" loophole makes no sense and is not fair.

If the U.S. Supreme Court (aka Citizens United) calls corporations "people" for their political contribution rights, then they should have equal rights for taxation, too.

Thank you for all your work on this; please support HB 36.

Sincerely,
Mary Ver Hoef
Fairbanks, Alaska

Laura Chartier

From: lauren moss [REDACTED]
Sent: Thursday, March 30, 2017 8:34 PM
To: Laura Chartier
Subject: HB 36 Testimony through the Chairman of the House Labor and Commerce Committee

For the Record:

To the hearing of the Labor & Commerce Committee for HB 36:

I support House Bill 36. Currently Alaska receives no revenue from S corporations, all other non-C Corporations, and any other high profit business. I support removing the loophole for these corporations and businesses if they make more than \$200,000 in profits. Alaskans believe all businesses and corporations should pay their fair share to support the revenue stream of our great state. Thank you.

Lauren Moss
NHN John's Rd.
Soldotna, Ak. 99669

lolly@gci.net

Laura Chartier

From: Chris Prussing [REDACTED]
Sent: Friday, March 31, 2017 3:03 PM
To: Laura Chartier
Subject: House Bill 36

"Currently Alaska receive's no revenue from S corporations, all other non-C Corporations, and any other high profit business. Our bill removes the loophole for corporations & businesses if they make more than \$200,000 in profits."

Thank you for the notice, I am unable to attend to testify, but I think this bill is a great idea, and support it.

Chris Prussing
4655 Thane Road
Juneau 99801

Laura Chartier

From: name family name [REDACTED]
Sent: Thursday, March 30, 2017 9:48 PM
To: Laura Chartier
Subject: House Bill 36

I support it!

Steven Bell
Anchorage, AK
907 830-1620