

**ALASKA STATE LEGISLATURE**  
**HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS**

March 3, 2004

7:05 a.m.

**MEMBERS PRESENT**

Representative Mike Hawker, Chair  
Representative Bruce Weyhrauch, Vice Chair  
Representative Dan Ogg  
Representative Norman Rokeberg  
Representative Ralph Samuels  
Representative Peggy Wilson  
Representative Max Gruenberg  
Representative Carl Moses

**MEMBERS ABSENT**

Representative Vic Kohring

**COMMITTEE CALENDAR**

HOUSE BILL NO. 493

"An Act relating to adoption and revision of a long-term fiscal plan for the State of Alaska."

- HEARD AND HELD

CORPORATE TAX ISSUES

- HEARD

OIL PRICE PROJECTIONS

- CANCELED

**PREVIOUS COMMITTEE ACTION**

BILL: HB 493

SHORT TITLE: LONG TERM FISCAL PLAN

SPONSOR(S): REPRESENTATIVE(S) HARRIS

02/16/04	(H)	READ THE FIRST TIME - REFERRALS
02/16/04	(H)	W&M, FIN
02/25/04	(H)	W&M AT 7:00 AM HOUSE FINANCE 519
02/25/04	(H)	Heard & Held
02/25/04	(H)	MINUTE(W&M)

03/03/04

(H)

W&M AT 7:00 AM HOUSE FINANCE 519

**WITNESS REGISTER**

CHUCK HARLAMERT

Juneau Section Chief

Tax Division of Administrative Services

Department of Revenue (DOR)

Juneau, Alaska

POSITION STATEMENT: Presented general outlines of the corporate income structure in Alaska and the effects of changes to that structure during the discussion of HB 493.

DAN DICKINSON, Director

Tax Division

Department of Revenue

Anchorage, Alaska

POSITION STATEMENT: Answered questions about tax issues related to HB 493.

MIKE WILLIAMS, Revenue Auditor

Tax Division

Department of Revenue

Anchorage, Alaska

POSITION STATEMENT: Testified during the discussion of tax issues related to HB 493.

**ACTION NARRATIVE**

**TAPE 04-11, SIDE A**

Number 0001

**CHAIR MIKE HAWKER** called the House Special Committee on Ways and Means meeting to order at 7:05 a.m. Representatives Hawker, Samuels, Weyhrauch, Wilson, Gruenberg, Moses, and Ogg were present at the call to order. Representative Rokeberg arrived as the meeting was in progress.

HB 493-LONG TERM FISCAL PLAN

Number 0109

CHAIR HAWKER announced that the only order of business would be HOUSE BILL NO. 493, "An Act relating to adoption and revision of a long-term fiscal plan for the State of Alaska."

CHAIR HAWKER reviewed past discussions of HB 493 and stated that today's meeting is for the purpose of discussing corporate tax structures and the corporate revenue component of the state's general revenue system.

Number 0339

CHUCK HARLAMERT, Juneau Section Chief, Tax Division of Administrative Services, Department of Revenue (DOR), introduced himself.

CHAIR HAWKER thanked Mr. Harlamert for preparing information for today's session. He asked Mr. Harlamert to address the issue of corporate tax structures and how it ties into how corporations are currently contributing to the state's treasury.

MR. HARLAMERT presented general outlines of the corporate income structure in Alaska and the effects of changes to that structure. [He referred to the Alaska Corporate Income Tax Primer, a handout in the committee's packet, throughout his presentation.] He began by explaining the basic two-part incidence for corporate income tax, as follows:

You have to be a corporation, and by that I mean a corporation for federal tax purposes, essentially, which means you can be a traditional C-corp or you can be another entity treated as a corporation for federal tax purposes. The second incidence - or component - of being subject to the Alaska corporate income tax is that you do business in the state.

Number 0548

CHAIR HAWKER asked Mr. Harlamert if he would explain C-corporations and S-corporations.

MR. HARLAMERT explained that any incorporated entity is a legal corporation, but for federal tax purposes, qualified corporations, those with less than 75 individual shareholders, may elect to, under Subchapter S, be treated as an S-corporation. Subchapter S is Internal Revenue Code (IRC) Section 1362, he added. A corporation that makes a Subchapter S election is treated like a partnership, unlike a regular corporation that is itself a taxpayer. It passes through its earnings to shareholders who, as individuals, pay taxes on those earnings.

Number 0721

CHAIR HAWKER pointed out that a C-corp is a corporation that is organized under Subchapter C of the IRC, and is a separate tax-paying entity. If it gives dividends, the shareholders have their own tax consequences, he explained. However, some of the IRC codes allow some corporate structures to elect to be taxed in another manner that avoids taxation at the entity level, but passes all of the potential tax consequences on to the individual shareholders. Those are S-corps and other contemporary corporate structures.

MR. HARLAMERT responded that S-corps have been around for a long time, and the new vehicle for tax planning is the limited liability company (LLC).

MR. HARLAMERT referred to the matrix on page 2, which shows various business entities: C-corps, S-corps, partnerships, LLCs with multiple members, LLCs with single members, and sole proprietorships. He pointed out that for tax purposes, the single member LLC is completely ignored.

Number 0936

CHAIR HAWKER asked for further clarification of LLCs and how they differ from C-corps.

MR. HARLAMERT explained that LLCs are another form of business entity allowed under state law, which have members with related interests in the equity and profits of the enterprise. They are flexible and don't fall under the traditional definition of a corporation or partnership because they have the limited liability of a corporation, but not the same organizational restrictions.

CHAIR HAWKER added that LLC stands for limited liability company, not corporation, because the entity has a liability and the individual shareholders can be isolated from corporate liability. The advantage of a LLC, as opposed to a corporation where there are individual shares of stock that can be classed, but have equal rights and equal claims on the assets of the corporation, is that it can be used very flexibly to allow disproportionate allocations and distributions to different classes of "members", not shareholders. He called LLCs "a creature of contemporary tax law." He said it is important to keep an eye on LLCs because of the tax choice available to it.

Number 1212

MR. HARLAMERT reviewed the status of the various business entities and their federal income tax status. He said that C-corps are themselves a taxpayer and are responsible for tax on their earnings directly. An S-corps passes its earnings through to its shareholders who pay the tax directly. Partnerships follow the same pass-through treatment whereby the income is passed through proportionally to its partners. An LLC can elect any of those treatments so it is hard to tell by looking at it what its tax status is, he remarked, and whatever an LLC elects would control state taxation.

REPRESENTATIVE WEYHRAUCH inquired if the S-corp is required to pass all of its earnings on to the shareholders, under federal law.

MR. HARLAMERT replied both S-corps and partnerships are required to pass 100 percent of their taxable earnings each year through their shareholders.

REPRESENTATIVE WEYHRAUCH asked if a C-corp could also pass its earnings out to either its employees or its shareholders.

MR. HARLAMERT remarked that that it could, but the difference is that earnings of a C-corp get distributed in taxable dividends. Dividends to individuals are taxable 100 percent; [dividends to] corporate shareholders may not be taxable at all. The biggest difference is that [dividends] are not taxed to the owners until distributed, and then they are double taxed.

REPRESENTATIVE WEYHRAUCH wondered at what point the State of Alaska could obtain any of those funds from a C-corp or an S-corp for its treasury.

Number 1503

MR. HARLAMERT responded that the state would collect corporate income taxes from the C-corporation every year when it makes a profit, and it is indifferent as to when it distributes the profits to shareholders. The S-corporation would never pay state tax, and neither do their shareholders.

REPRESENTATIVE WEYHRAUCH said, "So we've got a C-corp that does pay some tax to the state, we've got an S-corporation that does not pay tax to the state -- now an LLC?"

MR. HARLAMERT responded, "An LLC may or may not, depending on how they elected it. If they made the federal election to be treated as a C-corp ...."

Number 1612

REPRESENTATIVE WEYHRAUCH said, "We may be looking at whether to increase the tax on the C-corp, if at all, to impose tax on an S-corporation, if at all, because it's not taxed at all, and whether to impose a tax on an LLC because it's not taxed at all. Are those the three policy decisions?"

MR. HARLAMERT replied that, in essence, Representative Weyhrauch is right, but the way to state it would be to say, "The policy decisions, if they're being entertained, are to tax S-corps and partnerships, and by virtue of taxing those two business entities, you will indirectly reach every LLC."

REPRESENTATIVE WEYHRAUCH asked if LLCs are being looked at in two ways, as an S-corp and as a single-owner LLC.

MR. HARLAMERT replied, "Yes, you could just tax all the entities."

Number 1725

REPRESENTATIVE GRUENBERG asked if any states or localities tax S-corps or LLCs that elect to be treated as S-corps?

MR. HARLAMERT answered that most states tax business profits through a corporate income tax and, mirroring the federal government, have an income tax that picks up anything that doesn't flow through the corporate income tax.

REPRESENTATIVE GRUENBERG said that was not his question.

MR. HARLAMERT said there are some states that don't tax individuals, but do tax business entities directly.

REPRESENTATIVE GRUENBERG indicated that when he has traveled to conferences on business taxation, the main issue seemed to be nexus. He asked if that is the main issue today.

MR. HARLAMERT said that is a significant issue nationwide.

REPRESENTATIVE GRUENBERG asked Mr. Harlamert if he intends to spend any time on that issue today.

CHAIR HAWKER replied, "We certainly do."

Number 1858

REPRESENTATIVE WILSON said when she looks at this issue, she realizes that many corporations in Alaska are set up so that they can get away from taxes. She asked what effect a tax would have on those businesses, the town they're in, and the state.

CHAIR HAWKER clarified that corporations are taxed in Alaska; it's individuals that are not taxed.

REPRESENTATIVE WILSON wondered what the ramifications to the state would be if the businesses that are currently not paying taxes were to begin paying them. She wondered how big the ramification would be.

CHAIR HAWKER asked for Representative Wilson's indulgence and replied that the question would be answered shortly.

Number 2045

REPRESENTATIVE SAMUELS asked if, under federal income tax, the C-corps are the only ones that paid tax on the same money twice; they pay the corporate income tax, and then there is a distribution to the shareholders who pay an income tax on those earnings. He asked if that is a fair statement.

MR. HARLAMERT replied that it is a fair statement.

REPRESENTATIVE SAMUELS then asked, "Other than the oil industry, how does someone like Wal-Mart pay a corporate income tax in Alaska? Do they have to show costs and sales in Alaska, or do you take a percentage of their sales nationwide?"

CHAIR HAWKER said he believes Representative Samuels is about one page ahead of [the testimony]. Chair Hawker recognized that Representative Rokeberg had arrived. He asked Mr. Harlamert to address the topic of sole proprietors and how they are taxed.

MR. HARLAMERT explained that sole proprietors are unincorporated, or unorganized, businesses operated by individuals who pay tax on their profits.

Number 2235

CHAIR HAWKER referred back to the chart on Alaska tax status and asked Mr. Harlamert whether sole proprietors are subject to Alaska corporate income tax (CIT) and the owners subject to CIT.

MR. HARLAMERT pointed out that the second row [on the chart], the entities' Alaska tax status, really doesn't need to be there because the IRS code is adopted [for them] and the federal tax status controls [them] under Alaska law.

MR. HARLAMERT continued to explain that in row three, C-corps are the primary taxpayer subject to CIT. S-corporations, technically are taxpayers, but because the incomes pass through, they don't pay tax, except in rare cases. A partnership is not a corporation and the entity itself is not subject to CIT. An LLC can be any one of the prior three [categories] for tax purposes, subject to Alaska CIT, or not, depending on what the company elected to do. Few of those elect to be taxed, he added.

Number 2427

MR. HARLAMERT, to answer the question if owners are subject to Alaska CIT due to an entity's income or activity in the state, looked at the fourth row of the chart. In general terms, a corporation is responsible for itself, and not its owners, unless it is owned by another corporation and is taxed directly for its business in the state, he explained. S-corporations' owners do not have a state tax consequence because they are individuals.

CHAIR HAWKER added that individual owners of a corporation that elects taxation under the Subchapter S rules are not subject to earnings realized because they own a corporation that elects to be taxed.

MR. HARLAMERT explained that in corporations with partnerships both the income and the business activity are attributed to the corporate owner.

REPRESENTATIVE GRUENBERG asked if a joint venture would be the same as a partnership for the purposes of the chart.

Number 2630

MR. HARLAMERT replied that it would. He continued to explain that LLCs that elect to be treated as corporations are subject to be taxed. If they elect an S-corp, tax is irrelevant. If

they elect a partnership and they have a corporate member, they can be subject to tax.

REPRESENTATIVE WILSON asked what most LLCs in Alaska elect to do.

MR. HARLAMERT answered that he didn't know exactly, but guessed that most would elect S-corps or partnerships so they would not subject themselves to state tax. Those that are owned by corporations are "indifferent" and vary a lot, he added.

CHAIR HAWKER asked Mr. Harlamert to discuss rows five and six, when an entity makes a distribution to its owners and how it is treated under federal and state statutes.

Number 2830

MR. HARLAMERT began his explanation by addressing C-corps, S-corps, and partnerships. A C-corp pays its taxes as a taxpayer, and when it pays a dividend out of earnings, that is, essentially, a separate taxable transaction, he said. The shareholder will pay tax on his or her earnings. If it is a corporation there are elements of the law that allow deductions of all - or a significant portion - of those dividends in order to eliminate double or triple taxation. For S-corps, in general, distributions are tax free under the theory that tax on that income has been paid as it has been earned. In partnerships, distributions can be taken out to the extent of what has been put into the partnership and taxed already. There is no double taxation at the federal level of S-corp or partnership distribution, he summarized. For LLCs, again it depends on what the LLC has elected to be, he said.

REPRESENTATIVE ROKEBERG inquired if it is possible for the state to statutorily mandate the election of an LLC into a C-corp.

MR. HARLAMERT said he does not believe so. He said he does not think the state has the authority to mandate any taxpayer's federal tax elections. He suggested state law would have to be changed to do so.

REPRESENTATIVE ROKEBERG replied that Mr. Harlamert's answer is, "Yes, and no."

MR. HARLAMERT responded, "We would do it in an entirely different way."

Number 3052

CHAIR HAWKER asked Mr. Harlamert to continue the discussion and to look at some of the industries in the state and what they have contributed, as well as to look at industries that have activities in more than one state.

MR. HARLAMERT drew the committee's attention to the next page of the packet and described it as a summary of tax liabilities reported on tax returns received over the last six fiscal years. He noted the biggest point was that oil and gas are averaging roughly 80 percent of the total.

CHAIR HAWKER asked Mr. Harlamert to clarify the title of the heading "Non-Petroleum Corporation".

MR. HARLAMERT responded that that is a misprint because he had the title adjusted at the last minute to include oil and gas and that change didn't get picked up.

CHAIR HAWKER indicated that "Non-Petroleum Corporation" should be deleted and it should be called "Tax Liability by Sector".

MR. HARLAMERT replied, "Right."

CHAIR HAWKER said, "It would appear that we are somewhat dependant on oil and gas in this state."

MR. HARLAMERT agreed.

CHAIR HAWKER pointed out that the first line regarding the airline industry shows a decline [in tax liability]. He asked Mr. Harlamert to say more about that.

MR. HARLAMERT said that the bulk of that line is actually cargo transportation airlines, and the passenger element is small, spotty, and not stable in terms of profits.

REPRESENTATIVE GRUENBERG said what catches his eye is the amount of variation, by year, in the oil and gas industry just because it is such a large number. He said the other industries vary terrifically, as well. He wondered why they vary so much.

MR. HARLAMERT answered that the non-oil and gas corporate income tax sector does not vary as much as the oil and gas section does, in part, because it's made up of 3,000 corporations out of the 12,000 taxpayers that pay income tax on a regular basis.

The oil and gas sector is made up of a much smaller group, he said, so part of the difference is due to diversification. He pointed out that in this period [FY 1998 to FY 2003] it fluctuated between \$41 million and a little over \$50 million, which is a 20 percent change.

REPRESENTATIVE GRUENBERG remarked that the bottom line [Total] in year 2001 is remarkably different from that of 2002.

MR. HARLAMERT attributed most of that difference to oil and gas corporations which are much more volatile.

Number 3525

DAN DICKINSON, Director, Tax Division, Department of Revenue (DOR), in response to the discussion [of page 3 of the handout, Tax Liabilities by Sector], pointed out:

These [figures] are the cash payments that we received from corporations during the fiscal year. They don't represent that year's taxability on a filed return. As such, when you have huge fluctuations in prices such as we had in 1999, what you have is taxpayers underestimating and then overestimating. Every quarter they have to file an estimated amount so that at the end of the year they've made up their correct liability. Essentially, what you see is very wide swings as price swings occur and they overestimate and then underestimate, or visa versa.

MR. DICKINSON said the next step would be to look at the actual quarterly filings.

MR. HARLAMERT pointed out that the schedule consists of reported liabilities and does reflect the tax liability report on the tax return, which does not match up with collections. He said the point that Mr. Dickinson is making is absolutely correct; the revenues don't match up with what is reported on tax returns because of the time difference between estimated tax payments and their compounding effect when taxes go down. He explained that the chart had been developed off of reported liabilities. He said, over time, it all works out. Revenues tend to be more stable, but in periods like the last couple years of significant decline in corporate liabilities, the prepayments that exist on the books get applied to the next year. The decline and overall liability is amplified by large relative prepayments, and so the

cash receipts can fluctuate a lot more than liabilities. He noted that is the point Mr. Dickinson was trying to make.

CHAIR HAWKER pointed out that footnote 1 highlights that point.

REPRESENTATIVE WILSON asked what was actually collected.

MR. HARLAMERT replied:

In the non-oil and gas for FY 03, FY 02, and FY 01, respectively, we collected \$48 million, \$53 million, and \$59 million. In oil and gas we collected \$151 million, \$178 million, and \$338 million, so if I add that up, I get \$199 million, \$231 million, and approximately \$390 million. So in FY 03 we collected \$199 million and liabilities were \$258 million, a substantial difference.

CHAIR HAWKER indicated that it equals out over time. It has a beginning period and an ending period, and payments are made at the end of a quarter, he said. He described it as fiscal-year accounting versus cash-basis accounting. He said he does not want to give the impression that "we look at numbers here, and these are not being paid."

Number 3931

REPRESENTATIVE WILSON wondered why it doesn't just say what was collected.

MR. HARLAMERT responded that would be just as valid a number, but what was collected could not be separated in terms of industry. He said it is collected and posted to a taxpayer's account after a return is received, and those collections don't necessarily land in a specific year. There is money on account from taxpayers and it gets assigned to liabilities as the returns roll in. There is not an opportunity to broadly assign those revenues, and it is not possible to assign specific receipts to industries.

REPRESENTATIVE WILSON asked if there is a benefit for a company to overstate or understate their liabilities.

Number 4055

CHAIR HAWKER asked Mr. Harlamert to discuss fraud and penalties.

MR. HARLAMERT suggested what Representative Wilson is referring to is accelerating or deferring payment, as opposed to "misstate your liability," and said there are requirements in the statutes that require taxpayers to pay their estimated tax or suffer penalties if they underpay it. Typically, corporations slightly overpay to avoid penalties.

CHAIR HAWKER requested that Mr. Harlamert move on to page 4, which deals with Representative Samuel's question about multi-state apportionment.

MR. HARLAMERT described page 4 as a very over-simplified version of how multi-state taxation works. Each taxpayer falls into one of two categories; their business is either wholly in the state or it is a multi-state business. He explained: "For your typical ma-and-pop operation, just in Alaska, it's a simple matter of taking your federal taxable income, making a few adjustments, applying the tax rates, and that's your tax liability."

CHAIR HAWKER requested a quick synopsis of Alaska corporate income tax (CIT) structure.

Number 4307

MR. HARLAMERT explained that it is based on federal taxable income or what is reported on the federal tax return. "A series of adjustments are made for non-oil and gas corporations, federal interest is removed from taxable income, deductions for state income tax is added back, and that is the Alaska tax base on which variable rates from 1 percent to 9.4 percent of income over \$90,000 are applied," he said.

MR. HARLAMERT pointed out that a multi-state business is complicated because the portion of income to be properly taxed in Alaska has to be determined. A method called apportionment, or combined reporting, is used, which takes the total income of the business and multiplies it times the Alaska apportionment factor to come up with income subject to tax in Alaska. At that point the tax rates are applied to calculate the tax, he concluded.

Number 4437

CHAIR HAWKER commented that determining the "slice of the pie" becomes very interesting.

MR. HARLAMERT said the standard method is the three-factor apportionment formula: the ratio of sales in Alaska to [sales] everywhere, and the ratio of payroll of Alaska compared to payroll everywhere, and the ratio of Alaska property to property everywhere. The average of those three factors is the apportionment factor. He noted a simple explanation on the bottom of page 4.

CHAIR HAWKER emphasized that under Alaska apportionment, equal weighting is given to each of the factors.

MR. HARLAMERT said that isn't the way it has to be done, but is the way it has been done in Alaska. He pointed out that oil and gas companies, those who have production or a pipeline in the state, have used a modified apportionment, which substitutes for a payroll factor and an extraction factor.

Number 4624

REPRESENTATIVE SAMUELS asked if a major corporation shows a loss nationwide, do they recoup in Alaska. He gave an hypothetical example; if IBM made money in Alaska, but lost money nationwide, Alaska would not get money from taxes.

MR. HARLAMERT replied that is exactly right.

**TAPE 04-11, SIDE B**

Number 4640

MR. HARLAMERT continued, "The reasoning was based on the premise that you cannot legitimately segregate, through separate accounting, the actual earnings or value derived from a given state." He said it is very difficult, acrimonious, and inefficient.

REPRESENTATIVE SAMUELS speculated that, except for oil and gas, there are no sales for other resources. Fishing companies buy the fish here and don't sell any of it elsewhere. In timber companies nothing gets sold here, he said. He asked if that is correct.

MR. HARLAMERT said that is generally correct. Sales are attributed to states based on a destination sales basis where the product is delivered to the customer.

CHAIR HAWKER said, "With the sales, the transference of risk of ownership transfers to the buyer."

MR. HARLAMERT replied, "Not necessarily. It can transfer here, but be destined for another location. The destination principal ..."

CHAIR HAWKER explained that this [discussion] is leading to taxation of net income of a corporation or operation. "The sales factor for - let's use the oil and gas industry, particularly those people producing and selling oil - is arguable much less than what, in fact, they are selling the product for because the sale occurs outside the State of Alaska."

MR. HARLAMERT replied that the sales factor is virtually nil for most extraction industries because the destination of sales is out of state or, if there is a sale in the state, it is typically an intracompany transaction, which is not recognized in the sales factor.

Number 4353

MIKE WILLIAMS, Revenue Auditor, Tax Division, Department of Revenue, made an observation related to Representative Samuel's point about the corporation with the nationwide loss, but with income from Alaska. He said, "While it's true we don't get anything in that scenario, the reverse is equally true. If an Alaska operation loses money, but the corporation makes money nationwide, Alaska is getting revenue off of that."

REPRESENTATIVE SAMUELS made the comment that [the company] wouldn't do that very long. He asked about payroll in the fishing industry. He gave an example if he were to hire everybody [from] out-of-state, - virtually 100 percent of the people that work in Representative Moses' district come from the Lower 48 - he wondered if the payroll is where the check is delivered, where the money is earned, or where the person lives. He also wondered how much audit function the state has [in that situation].

MR. HARLAMERT replied that the payroll factor is assigned based on where the wages are earned.

CHAIR HAWKER summed up the discussion so far. He asked Mr. Harlamert to explain how income tax is only one component of taxation levied on extraction industries.

Number 4151

MR. DICKINSON explained that, overall, taxes other than in oil and gas represent under \$30 million a year for all other extraction industries. He said the single biggest share of government "take" from the gas and oil industry is royalties because of the state's owning the lands, which is about 40 percent of the revenues. The other 60 percent comes from three types of taxes: a production tax - a charge per barrel produced, an income tax, and a property tax on oil and gas assets. Roughly speaking, the numbers are 48 percent from royalties, 42 percent from production tax, and the remainder from income and property taxes, he said. He mentioned that the production tax has been declining rapidly over the past several years. There have been times that changes in the corporate income tax were made to try to recoup the losses in the production tax.

CHAIR HAWKER pointed out to the committee that there is a document in the packet called "Alaska's Petroleum Revenues - An Overview", which is very informative about the previous topics.

REPRESENTATIVE ROKEBERG returned to the destination taxation issue and asked Mr. Harlamert about timber manufacturing exportation.

MR. HARLAMERT said there would be no tax paid on exporting timber, assuming the company is a corporate taxpayer, but, in general, when exporting products or services, the sales are attributed to the destination state, assuming nexus is in place. He continued:

There is a special rule if you are selling into a jurisdiction where you do not have nexus - are not a taxpayer - that you throw those sales back to the origination state. In a case of an Alaska company that makes sales outside of the state, tax would still be collected on 100 percent of their income if they did not have a business presence outside of the state, but merely made export sales. For a company that is worldwide and has a presence in every state, those sales are attributed to the other states for tax purposes and dilute Alaska income.

Number 3620

REPRESENTATIVE ROKEBERG asked if there is a way to avoid paying taxes on those intrastate sales, and if that would create a

barrier to encouraging value-added manufacturing. He wondered if a major producer would be reluctant to sell oil or gas for processing in Alaska if they would have a higher incidence of sales in terms of the corporate income tax calculation. He asked if it would be a barrier and a disincentive to local investment.

MR. HARLAMERT said, arguably, yes. When an oil manufacturer in the state makes a sale to an unrelated party in the state, it indirectly increases their Alaska CIT. He opined that there would not be enough sales activity to make a material difference.

REPRESENTATIVE ROKEBERG responded that perhaps Mr. Harlamert was right when speaking about a large multi-national corporation, but it might affect a medium-sized or small company's overall sales.

MR. HARLAMERT said the impacts do differ depending on the size of the company. He turned to the next page as a segue into the choices of apportionment factors between states. He said there has been a substantial shift away from the traditional three-factor apportionment scheme of property sales and payroll, to a tendency to overweight the sales factor. "The theory behind that is you shift the tax away from your in-state producers who are selling out-of-state, and to out-of-state manufacturers selling in-state."

Number 3344

REPRESENTATIVE ROKEBERG said that works "if you're primarily a consumption state. If you're primarily a production state, it doesn't work." He asked if Mr. Harlamert agrees.

MR. HARLAMERT said it is a very good observation and it is primarily for a state that has a significant market and is trying to be more competitive relative to other states in manufacturing. He referred to the next page, Impact of Factors Based on Average Revenue for FY 98-FY 03, to point out that it doesn't work for extraction companies.

REPRESENTATIVE GRUENBERG asked how to solve the problem of the consumption state versus the production state.

Number 3226

MR. HARLAMERT explained that [Alaska] can't compete on the basis of overweighting the sales factor and benefiting manufacturers, at the expense of out-of-state manufacturers, and coming out ahead. What [Alaska] has done in the modified apportionment scheme for oil and gas companies is substitute the extraction factor for the payroll factor. He said he thought it was a matter of negotiation that sales were left in. He said the focus is on oil and gas companies because they represent 80 percent of [Alaska's] revenue and the exact implications of changes.

MR. HARLAMERT said the analysis [of page 6] goes over the impacts of changing the apportionment factors. He said the first column is current law, which shows the average factors of the industry, with some weighting, to get to revenues. "They're not the nominal average," he added. The total is the average revenue over the last six years of \$209 million in corporate income tax receipts.

MR. HARLAMERT explained that in column two where the extraction factor is doubled weighted, similar to the way other states double weight the sales tax factor, and the average factor increases to 9.5 percent. There would be a \$20 million change in revenues, or just under 10 percent, he said.

MR. HARLAMERT continued to say column three shows what would happen if the sales factor is eliminated. It is the opposite of what most states are doing, he said. There would be a significant increase in revenues. Of the other three examples, single factor extraction is the most dramatic change to industry. The main point is that the sales factor is diluted because of the nature of the industry, he concluded.

CHAIR HAWKER asked if that concept applies to extractive industries in general.

MR. HARLAMERT replied that he thinks so.

REPRESENTATIVE ROKEBERG returned to his former question and asked, by eliminating the sales factor, would it neutralized or enhance local sales.

MR. HARLAMERT answered that it would neutralize, or have no effect, to remove the sales from the calculation of the tax. For the large companies it is probably not a consideration and for small companies it's just "doing business." "Tax consequences don't control business decisions as much as we might worry [that they do]," he added.

Number 2754

REPRESENTATIVE ROKEBERG suggested that looking further at this issue might be a way to create a public policy incentive.

CHAIR HAWKER agreed that it is a way that apportionment factors could be applied.

MR. DICKINSON said even medium-sized corporations have billions of dollars in sales, and there never will be local sales that will approximate those larger sales.

CHAIR HAWKER asked Mr. Harlamert to speak about alternatives other states have looked at.

MR. HARLAMERT discussed page 7, general alternatives that are available to change the corporate income tax structure. He said the first one is an estimate of the impact on oil and gas, as well as on other corporate taxpayers, when changing the corporate tax rate by 1 percent. The second line item shows what would happen with the elimination of federal credits which are apportioned to Alaska. Enhanced oil recovery credits are awarded for activities in California, for example, he said. The vast majority fall strictly on oil companies.

REPRESENTATIVE GRUENBERG asked if carbon sequestration entered into this as one of the credits.

MR. HARLAMERT said he doesn't know. He said the theory behind eliminating federal credits is that it is not specific to activity in Alaska, although it could be. The natural next step would be to replace credits for activity in Alaska, he predicted. He talked about allowing enhanced oil recovery (EOR) credit for Alaska projects and said it would cost the state \$6.2 million.

Number 2230

MR. HARLAMERT moved on to the subject of taxing net capital gain at ordinary rates and explained that years ago, the federal tax code taxed capital gain at favorable rates, and when it was changed, Alaska laws did not change with it, but retained the favorable rate that caps capital gain at 4.5 percent. If that were to be changed to fall in line with the federal treatment of capital gain, it would benefit the state by about \$2 million a year.

REPRESENTATIVE WILSON asked if most states had adjusted [capital gain rates] to match the federal rates.

MR. HARLAMERT said he couldn't answer that question because so many states have an independent tax structure, whereas other states adopt the federal tax law in full.

MR. WILLIAMS said there are only two states which currently allow an alternative rate or a reduced rate on capital gain, Alaska and Hawaii.

MR. HARLAMERT said existing law allows restricting net operating loss (NOL) usage to carryforwards. It is used for a corporation that has incurred a loss, to carrying it back and apply it against tax on income for three years back, and then carry it forward. Many states don't allow that, he said.

CHAIR HAWKER asked Mr. Williams if he has statistics on that.

MR. WILLIAMS said he does not have that information with him, but said he thinks that about 20 states have restricted NOL carrybacks.

Number 1947

MR. HARLAMERT pointed out that this issue would generate a short-term cash inflow.

MR. HARLAMERT noted that a bigger issue is taxing S-corps under Alaska CIT which would generate just over \$29 million a year, a conservative estimate, he opined. He explained that the status of corporations could easily change, so the estimates are static.

MR. WILLIAMS reported that 22 states have restricted NOL carrybacks.

CHAIR HAWKER asked Mr. Williams about research on the nine states that do not have individual income taxation. He asked how those states deal with the entity level tax on the flow-through organizations.

Number 1722

MR. WILLIAMS replied that a couple of states have an outright income tax on those entities, and then there are a few states

that have a franchise tax on those entities. Washington does not care what type of entity is owned, and it taxes the business with the Washington Business and Occupation Tax. Of the other 43 states that do have personal income taxes, 18 of them also tax the entity or have some form of tax on the entity, in addition to the shareholders having to pay personal income tax.

MR. DICKINSON referred to a memo he sent to Representative Hawker.

CHAIR HAWKER said he has not distributed the memo to the committee.

REPRESENTATIVE ROKEBERG asked about the potential shifting of one business to another that had been mentioned. He said he believes there is a large migration from S-corp to LLCs at this time. He wondered if the LLC was part of the S-corp calculation [on page 7] versus the partnerships and sole proprietorships, and if there were statistics about migration to a different business formation.

MR. WILLIAMS said that LLCs are in the calculations for S-corps, partnerships, and sole proprietors because they have indicated their election for federal tax purposes. He said he doesn't have data to say how many of each there are.

MR. HARLAMERT said LLCs don't have a tax status by themselves, but are covered under another status. He said the tax on cruise ship income is the last category [on the chart]. He reviewed the history of when the DOR won a court case against interstate shipping companies that affirmed the right to tax entities despite a federal exemption that exists. The legislature modified the statutes to exempt those companies from taxation by adopting federal treatment for them. That removed cruise lines from the corporate tax systems. He said there are no good estimates for how much this kind of a tax would generate. He said his best estimation is \$6.8 million.

Number 1159

REPRESENTATIVE ROKEBERG asked if the \$6.8 million is based on the head tax rather than a corporate tax estimate.

MR. HARLAMERT said it is a rough estimate of a head tax as noted in the footnotes.

REPRESENTATIVE ROKEBERG spoke about a United States Office of Special Council (OSG) case which ruled that Alaska has special exemptions and could abrogate federal tax code in treaties with over 175 countries. Foreign vessels, including cruise ships, and exporting, could not be taxed by Alaska. It has had a huge impact on the air cargo industry in Anchorage, he said. He remarked that this looks like a handy target to add an additional tax burden to, but said Alaska runs the risk of annulling many treaties and drawing the ire of the State Department, Congress, and the United Nations. He said it seems like an easy thing to do, but that it is extremely difficult because of the international impacts. He cautioned the committee to be careful as they look at this issue.

CHAIR HAWKER asked Mr. Dickinson for alternatives to taxing the cruise ship industry.

MR. DICKINSON replied that DOR has looked at that issue and worked with the Department of Law to meet the concerns that Representative Rokeberg expressed. He said there were two mechanisms considered. One is a sales tax on certain tourist-related classes of activity, which two other states have already implemented. A sales and use tax could be placed on the amount a tourist paid for the trip to Alaska, for example, he said, and would fully meet legal requirements. The second area would be the use of a head tax or disembarkation tax, which other states currently have.

REPRESENTATIVE ROKEBERG said [those issues] need to be discussed further so everyone can "step up to the plate and pay a fair share."

CHAIR HAWKER thanked Mr. Harlamert for his contributions to the discussion of Alaska corporate income tax.

REPRESENTATIVE GRUENBERG said taxation of the cruise industry has been talked about, and asked if any states taxed the air or shipping cargo industry.

MR. DICKINSON answered that he is not aware of any.

REPRESENTATIVE GRUENBERG requested that Mr. Dickinson research that possibility.

Number 0507

CHAIR HAWKER turned the committee's attention to the Legislative Finance graph ["Alaska's Growing Fiscal Gap"] which has had some of the known financial issues added to it. He pointed that the top half of the graph above the zero line is the state general fund revenue forecast, and below the zero line is the projected deficit showing what would happen if nothing is done. "The do-nothing picture," he added. He said one component factored in is a 10 percent annual increase in Medicaid, noting that in the past six years the annual growth has been between 17 and 18 percent. Another component is the under funding of both the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS). A third component is a 2 percent inflation factor. He explained that the yellow bar is the fiscal gap today with a \$2.3 million general fund budget, and he pointed out how the gap grows as revenue declines without adding the other factors in. The bottom four colors are the components added in, he said.

REPRESENTATIVE WILSON responded that [the state] would not even be able to take care of the mandated services.

REPRESENTATIVE ROKEBERG said he appreciates seeing the graph and said it is very helpful. He explained that the FY 05 budget numbers are omitted on purpose so that a graph would not begin to drive public policy because the legislature is in the middle of negotiations.

CHAIR HAWKER said in this graph the FY 05 budget is as the administration has submitted it.

Number 0032

REPRESENTATIVE ROKEBERG related that the amount of the fiscal gap, \$476 million, makes some assumptions as to whether or not some of those things will be done. The graph is meant to avoid controversy, he added. He suggested a total column be added, a line item that would total the fiscal gap and the other elements together, titled "adjusted real projected."

**TAPE 04-12, SIDE A**

Number 0001

CHAIR HAWKER offered, "The real problem."

REPRESENTATIVE GRUENBERG asked if Representative Rokeberg is talking about totaling the factors and the fiscal gap, and then subtracting that sum from the general fund revenue.

REPRESENTATIVE ROKEBERG answered, "So that there is one line item that would show what the total gap would be."

CHAIR HAWKER clarified that Representative Rokeberg is asking for a total that is the plot point at the bottom of each of the vertical bars. He emphasized that one of the reasons a total was not done is because the numbers are approximations, and he noted that the whole point of the graph is to show the macro perspective; this is a large and growing problem. He said he worries about creating a false precision because these factors are not the only "time bombs" in the budget. There are other issues, and other alternatives available for the "green section" or money available for appropriation, he emphasized.

REPRESENTATIVE GRUENBERG suggested a horizontal total, also.

CHAIR HAWKER said he would refer those ideas to Legislative Finance.

REPRESENTATIVE ROKEBERG said that in FY 07 there is, above the fiscal gap, \$305 million accumulative added to the structural fiscal gap of \$265 million, which is \$1.17 million. The main point [of a total line] would be to show the public the higher number. He said he takes slight exception to Representative Gruenberg's idea of a horizontal total because it would not fit on the page, and the cumulative effect of TRS and PERS does not have any meaning unless you look at the real numbers.

CHAIR HAWKER made the point that the state does not come to an end in year FY 14.

REPRESENTATIVE OGG said the meeting has been very informative about tax rates. He pointed out that, according to the constitution, the earnings out of the permanent fund go into the general fund. He said he would like to see the graph with projected earnings of the permanent fund under the present mechanism added on. It opined it would be a truer reflection of what the state's revenues actually are.

CHAIR HAWKER said that is a good suggestion.

REPRESENTATIVE OGG said he is trying to figure out how to project something like that because it is market driven. He noted that the graph is about a ten-year spread. He suggested using the last 10 years' earnings as an example, although past performance is not future assurance.

Number 0702

CHAIR HAWKER said that is a number the permanent fund corporation has spent a great deal of time identifying; 10-year average returns. He noted it has been at about 8 percent. He suggestion caution because of the question of whether to show the earnings available as if they were never touched.

REPRESENTATIVE OGG suggested it could be broken out as to what portion has been used for dividends, state government, and unrestricted earnings. He said it would be interesting to see how it would change the yellow line [on the graph].

CHAIR HAWKER agreed it would be a fascinating presentation and said he would get Legislative Finance to help out.

MR. DICKINSON suggested that if the 8 percent permanent fund number is used, it has an inflation component built into it of about 3 percent, so care has to be taken not to built in inflation inconsistently.

REPRESENTATIVE OGG said the 8 percent number would be reflected if the percent of market value (POMV) method is adopted. He explained that what he is suggesting is to take what actually happened, market-wise, over the last 10 years, and set it at the top of the graph for the next 10 years. He said it is really hard to predict how the market would affect the permanent fund because, under the present mechanism, all realized earnings come out of it.

REPRESENTATIVE ROKEBERG suggested that the permanent fund corporation's future projections at about 7.89 percent, which are more accurate, should be used, whereas, in the past, the return on investment [ROI] was at 10 percent.

REPRESENTATIVE OGG said he understands what Representative Rokeberg is saying about future projections, but explained the way it works with the actual market is that all realized earnings come out and are put into the earnings reserve general fund account. When the actual market is followed, not many realized earnings came out when the market went down, he said. He added that what comes out is not being averaged right now.

Number 1108

REPRESENTATIVE ROKEBERG replied that he is unclear about what Representative Ogg is saying.

CHAIR HAWKER pointed out that in the committee packet there is also a nexus discussion, which is the "Commissioner Briefing Corporate Income Tax Outline, February 2003" and has apportionment details. He asked Mr. Dickinson to talk more about the graph that the committee has been discussing, which was taken from the "Executive Summary" out of the [Fall 2003, Revenue Sources Book, Tax Division, DOR]. He asked Mr. Dickinson to explain the strengths and weaknesses of the projected fund revenue.

MR. DICKINSON said, "If you look at the non-oil and gas revenues over this 10-year period, they average \$308.7 million. They swing from a high of \$313 million to a low of \$305 million." These revenues include corporate income taxes, sin taxes, tire tax, and car-rental tax. The remainder goes from FY 05, \$1.4 billion, down to FY 14, \$800 million, for oil and gas revenues. The production tax and royalties make up most of those revenues, which are driven by the amount of production and the market price. A decline curve driven mostly by a yearly 8 percent decline in Prudhoe Bay is built into the graph which has historically been too optimistic, he noted.

MR. DICKINSON spoke of the more volatile issue, oil price, which is of particular concern right now. The price of \$22 a barrel is significantly above the long-term average for the last 15 years. The highest price per barrel so far is this fiscal year where the average market price has been over \$30. In 1999, the price was \$12 per barrel. He emphasized that there was a great deal of volatility in oil price and the departments do their best to forecast what might happen. "Unlike the production forecast, in our price analysis we tend to be way too optimistic when prices are high, and way too pessimistic when prices are low," he said.

MR. DICKINSON continued to say that on March 9 another forecast will be made, and he predicts that prices will be considerably higher than what has been forecast. Even with a price of \$30 a barrel for FY 04, it will be necessary to draw from the constitutional reserve fund, he concluded.

Number 2010

CHAIR HAWKER added that the expense curve is not a linear curve. He summarized today's discussion of HB 493 and mentioned that

the bill needed further "wordsmithing" before it is brought back before the committee.

[HB 493 was held over.]

**ADJOURNMENT**

There being no further business before the committee, the House Special Committee on Ways and Means meeting was adjourned at 9:02 a.m.