

HOUSE FINANCE COMMITTEE
March 28, 2017
1:36 p.m.

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CALL TO ORDER

Co-Chair Foster called the House Finance Committee meeting to order at 1:36 p.m.

MEMBERS PRESENT

Representative Neal Foster, Co-Chair
Representative Paul Seaton, Co-Chair
Representative Les Gara, Vice-Chair
Representative Jason Grenn
Representative David Guttenberg
Representative Scott Kawasaki
Representative Dan Ortiz
Representative Lance Pruitt
Representative Cathy Tilton
Representative Tammie Wilson

MEMBERS ABSENT

Representative Steve Thompson

ALSO PRESENT

Brandon S. Spanos, Deputy Director, Tax Division, Department of Revenue; Representative Chris Birch.

PRESENT VIA TELECONFERENCE

None

SUMMARY

HB 115 INCOME TAX; PFD CREDIT; PERM FUND INCOME

HB 115 was HEARD and HELD in committee for further consideration.

Co-Chair Foster reviewed the agenda for the day.

#hb115

HOUSE BILL NO. 115

"An Act relating to the permanent fund dividend; relating to the appropriation of certain amounts of the earnings reserve account; relating to the taxation of income of individuals; relating to a payment against the individual income tax from the permanent fund dividend disbursement; repealing tax credits applied against the tax on individuals under the Alaska Net Income Tax Act; and providing for an effective date."

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BRANDON S. SPANOS, DEPUTY DIRECTOR, TAX DIVISION, DEPARTMENT OF REVENUE, addressed two questions from the previous day.

Co-Chair Foster interjected that Representative Birch joined the meeting.

Mr. Spanos continued that the first question was posed by Representative Pruitt regarding S Corporations. He indicated that there was no change in the treatment of S Corporations. He noted that S Corporations were taxed under the previous version, however, the current version of the bill provided more clarity on how to identify the source of its income. He identified AS 43.19 and AS 43.20 regarding the multi state tax compact referenced in HB 115 and delineated that the sections identified how to source Alaskan income. He added that the bill put the S Corporations "on the same playing field as any corporation" in the state. For most corporations, Alaskan property, payroll, and sales, were accounted for over property, payroll, and sales in other places and created an apportioned formula that determined Alaskan income. He likened the process to the state taking a slice of a large pie. He offered that income from S Corporations was passed through to the individual and the same formula was applied to determine the Alaskan slice of the income. Otherwise, "there were many games corporations could play" to exclude income the state would tax as Alaskan under C Corporation statutes.

Co-Chair Foster relayed that Mr. Spanos would be reviewing the fiscal notes on Thursday.

Mr. Spanos concluded that the current version of HB 115 in relation to S Corporations and Partnerships identified

Alaska sourced income from multi state or multinational corporations or partnerships. Without the specific language, litigation could result and the Department of Revenue (DOR) would have difficulty in administering the tax.

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Representative Pruitt asked whether an S Corporation would pay tax on all its earning or only the amount distributed to individuals. Mr. Spanos relayed that ultimately paying the tax was the individual's responsibility. A provision allowed the S Corporation to pay on the individuals behalf. He detailed that the S Corporation provided the K-1 form that identified the shareholders distributive share. Representative Pruitt was trying to understand what the S Corporation would have to file since the income was a "passthrough." He wondered why the state would mandate the S Corporation to file a return if the shareholders were filing. Mr. Spanos did not see a provision in the bill that required a separate filing for S Corporations. Representative Pruitt related that he had received questions from constituents regarding S Corporation filing. He concluded from Mr. Spanos' answer that S Corporations would not be required under the bill to do anything different or additional than currently required. He asked for reassurance. Mr. Spanos indicated that Representative Pruitt was correct.

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Co-Chair Seaton clarified that if an S Corporation retained money rather than distributing it to shareholders it would not be liable to pay a tax or file a form. Mr. Spanos confirmed Co-Chair Seaton was correct.

Representative Wilson wanted to better understand how the tax affected an Alaskan trust versus a nonresident trust. Mr. Spanos informed the committee that trusts were complicated. He delineated that a trust created by a resident would not be different than a trust created by a nonresident. Representative Wilson believed that the bill taxed residential trusts and nonresidential trusts differently. She reported that the state had "done a lot of work in the last few years" trying to attract out-of-state trusts to boost Alaskan banks. She ascertained that the lack of an income tax and the state's flexible banking laws

were the major attractants for nonresident trusts. She was trying to figure out how out-of-state trusts would be affected by the proposed tax and whether the earning would be taxed. Mr. Spanos responded that at a "very basic level" an individual resident could simply place assets in a trust to avoid paying a tax if resident trusts were not taxed. The department's consultant recommended taxing all trusts "to avoid any games" by broadening the base and lowering the rate. The administration had heard feedback favoring the state's treatment of trusts that provided protections from creditors and other protections as well as offering a tax haven due to the repeal of the income tax. He relayed that the protections were still in place under the proposed income tax. He interpreted that the bill would only tax Alaskan sourced income on nonresident trusts and trusts managed outside the state would not be a resident trust.

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Representative Wilson asked how much money had been invested in trusts in the state. Mr. Spanos did not know the answer to her question. He added that trusts received a deduction for the amount it distributed; if it distributed all its income it owed zero tax. He concluded that trust tax was based not on its assets but how much earned income that remained after distributions each year. Representative Wilson provided a hypothetical scenario of being a resident of Alabama with a trust in Alaska. She inquired whether the trust paid the proposed state income tax on its earnings if the trust made money in the state. Mr. Spanos responded in the negative but clarified the trust would pay a tax on earnings from assets held in the state. He communicated that the earnings were not subject to a tax if the income was earned through securities or some other asset that was not held in Alaska but was managed in the state. Representative Wilson asked whether she would be taxed on earnings if she had a trust comprised of only securities in the state. Mr. Spanos replied in the affirmative and offered that as a resident any income from a trust, regardless of where it was located would be taxed. Representative Wilson deduced that "it would be smarter" for a resident to maintain a trust in another state to avoid taxes. Mr. Spanos answered that distributions from the trust would still be taxed regardless of location. However, if the trust held the distributions income tax would not be owed. He furthered that Alaska was a "current destination" for trusts because of the lack of income tax.

Representative Wilson asked whether the trust was liable for state income tax if the trust was profitable, but the income was not distributed. Mr. Spanos responded that the answer depended on where the assets in the trust were located. He indicated that if the trust was "non-Alaskan" without any Alaskan assets the trust would not be taxed under the proposed income tax and if it was housed in another state without an income tax.

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Representative Wilson discerned that the earnings from the original income forming the trust would be taxed in Alaska, but if she subsequently moved the trust to a place without an income tax and did not take a distribution she would not owe any tax. Mr. Spanos thought that a trust attorney would advise her to do so but whether the move was beneficial depended on other factors. Representative Wilson remarked that it seemed that Alaskans would be penalized for having a trust in the state because the bill favored out-of-state trusts. She thought that Alaskans would move their trusts to more favorable tax regimes. She had a problem with the provision. She thought it was not fair to treat nonresidents more favorably than residents.

Co-Chair Seaton interjected that an Alaskan resident would pay a tax on income no matter where it was derived from. He emphasized that an Alaskan resident would pay an apportionment of taxes to another state with an income tax on income earned or assets held in the other state. If an Alaskan earned money in a state without an income tax the earnings were only taxable in Alaska under the proposed income tax. He offered that if an Alaskan earned income in a state with an income tax a credit was earned under the multi-state compact for the taxes paid to the state where the income was derived from.

Representative Wilson expressed confusion and wanted clarification. She provided the example of establishing a trust with a stock and bond portfolio in the State of Delaware; a state without an income tax and she did not take a distribution. She understood that since she did not take a distribution she was not subject to tax in Alaska. She furthered that if she maintained the trust in Alaska she would be taxed even if she did not take a distribution under HB 115. Mr. Spanos responded that Representative Wilson would not be taxed but the trust would be taxed. He

agreed that if there were no Alaskan assets in her Delaware trust, the trust was "a form of a tax haven." Representative Wilson reiterated her concerns regarding the legislation maintaining the favorable tax haven for nonresidents while taxing resident trusts. She believed that it would now be more advantageous for residents to take trusts out of state while the state was simultaneously encouraging nonresident trusts.

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Representative Pruitt conveyed questions from his constituents. He asked whether expenses related to a small business were a write off. Mr. Spanos answered in the affirmative and explained that it was similar to filing a federal return. Representative Pruitt asked about taxable amounts on IRA distributions and pensions. He wondered how Mr. Spanos thought the provisions regarding the items would drive the decisions of senior residents on whether to reside in the state or to leave. He spoke to taxing pensions and IRAs and asked "how big of a burden" the taxes would place on seniors. Mr. Spanos could not answer the question and added that the department did not obtain an economic study on the issue. He indicated that some states had an exemption or credits for seniors or other measures. Representative Pruitt was interested how taxing retirement income would affect some of the seniors under the poverty line. He reported that according to the Council on Aging the state had the fastest growing rate of senior citizens in the country and wanted to understand the economic impacts of a tax. He also asked about medical expenses being "under the AGI (adjusted gross income) line" on the proposed state income tax. He understood that significant medical expenses were not deductible under the state income tax. Mr. Spanos replied in the affirmative.

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Vice-Chair Gara referred to the comments regarding low income seniors. He reminded the committee that the bill exempted income below \$14.3 thousand per individual. Mr. Spanos agreed with the statement. Vice-Chair Gara indicated that for each \$1 thousand dollars of income the tax was 2.5 percent. He asked whether the statement was correct. Mr. Spanos indicated Vice-Chair Gara was correct. Vice-Chair Gara asked whether and Alaskan who wanted to remain in the state but avoid a tax on their trust would "locate their

trust in one of the nine states without an income tax." Mr. Spanos replied in the affirmative and qualified that the trust could also be in one of the states that did not tax trusts and in both instances the trust could only be comprised of "non-sourcable assets" such as securities and bonds. Vice-Chair Gara voiced that "he had no idea what the trust industry was in the state" and never received a clear explanation. He supposed that whoever "made money" on the trust industry in the state would pay taxes on their income. Mr. Spanos responded in the affirmative. Vice-Chair Gara inquired whether the bill would tax the income from a New York resident who had their trust managed in Alaska. Mr. Spanos indicated that was the intent of the bill.

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Vice-Chair Gara noted that historically in the state S Corporations, Limited Liability Companies (LLC), and Partnerships were taxed through distributions to individuals. He queried whether when the state abolished its income tax, these types of businesses were currently not taxed except for C Corporations. Mr. Spanos responded affirmatively.

Co-Chair Seaton clarified that a married couple filing jointly would not pay a tax if their income was under \$30 thousand. Mr. Spanos responded affirmatively. Co-Chair Seaton asked how administering the state income tax would burden the department in relation "to the earlier version." Mr. Spanos relayed that "the burden was significant either way." The newest version was more specific and directive than the previous version that was based on a progressive tax. He delineated that the current version of the bill identified Alaska sourced income for non-residents which provided clarity and specified how to apportion and allocate the income. The previous version was vague and would have forced the department to develop regulations which were out of the scope of DOR's authority or to rebuild the individual's federal return to determine the tax. The current version was "significantly simpler" to administer. He specified that the information necessary to determine the tax on Alaska sourced income used the federal AGI and the Alaska sourced income and applied the defined factor to a tax bracket that was the same as a resident's tax bracket. The formula, called the "Cal Method of Taxing" was developed in California. The method withstood

substantial litigation and was deemed valid. He favored the new version that "made many issues black and white."

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Co-Chair Seaton wondered about audits. He suggested that since the tax was based on the AGI the state could rely on federal Internal Revenue Service (IRS) audits. He asked whether he was correct. Mr. Spanos replied that using the AGI enabled DOR to rely on the IRS return, even if the return was not audited. He noted that the state or IRS could perform an audit. He shared that the chance of an audit incentivized correct self-reporting and for those who were audited, DOR was highly confident that the returns would be accurate. He indicated that a provision in the bill required an individual to file a new return if the IRS altered their tax return. The state currently shared information with the IRS regarding C Corporations, which could easily include individual tax payers. Co-Chair Seaton noted the difficulty for the state to hire auditors. He wondered whether more auditors would be available to do individual income tax audits versus oil and gas tax audits. Mr. Spanos answered that the topic was under discussion by the department. He reported that there were many more people that had experience in the individual income tax realm. However, if the income tax was instituted, income tax preparers would make more money in the private sector with the increased business in the state. He guessed that the scenario might make it challenging for the department to find qualified individuals. He conjectured that out-of-state individual income tax preparers, accountants, or auditors would be easier to recruit than oil and gas or corporate auditors.

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Co-Chair Seaton was attempting to determine the difficulty of filing the forms. He wondered about the burden for the individuals or businesses to file a return compared to the federal returns. Mr. Spanos hoped that everyone would file online. He communicated that currently the department's web portal for corporations made filing easy and guided the user through the process by choosing the simplest form and offered the least options. He suggested that the online system for individuals would require W-2 information and only ask several more questions pertaining to the state. Commercial software was adapted to include the state's

income tax forms added on as an option with federal tax forms. He indicated that if an individual was using a paper form a separate income schedule would be included. He anticipated a two-page form for paper filers.

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Representative Wilson wondered whether native corporation dividends would be taxed or exempted. Mr. Spanos responded that the dividends were taxed at the federal level and would be taxed at the state level. Representative Wilson cited statistics that oil and gas job wages were 11 percent of the total state wages amounting to \$2 billion, more than 2.5 times the overall average as of June 2016 and that the industry lost 3,000 jobs. She asked whether the statistics were incorporated into the calculations of how much revenue the state would gain from an income tax. Mr. Spanos responded that the department had used the 2015 available data from the IRS. Representative Wilson asked whether more current data was available that included the job loss figures. Mr. Spanos was not certain current data was available and would consult with DOR economists. He would provide the information to the committee. Representative Wilson thought "true numbers" were necessary going forward.

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Co-Chair Foster related that many native corporation shareholders in "northwest" Alaska did not pay federal taxes on their taxes due to loss carry forwards or other exemptions. He asked Mr. Spanos to expand on the subject. Mr. Spanos wanted to address native corporation's taxes first. He indicated that Alaska Native Corporations were for-profit businesses and were "definitely" taxed. A native corporation with net operating losses would not pay tax due to loss carry forwards. The dividends to shareholders would be taxed in the same way as they were taxed at the federal level. Co-Chair Foster informed the committee that many of the native corporations were formed in 1971 or 1972. He relayed that native corporations recently informed its shareholders that they were required to pay taxes on their dividends because the corporations were becoming more profitable.

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Representative Pruitt asked if the fiscal notes were based on the 2015 data. Mr. Spanos replied that if the department determined that "significant" information was available that would improve the fiscal note, the information would be included. He added that DOR had previously determined that the 2015 IRS data was the best information available. Representative Pruitt assumed better data meant more accurate. Mr. Spanos responded that the fiscal note data was a best estimate of future tax revenue. Representative Pruitt wanted to ensure the fiscal notes were "not going to make a statement." He could not find information in the bill about penalties and interest for non-payment. Mr. Spanos conveyed that the division had identified many administrative sections that were not included in the legislation but was aware that the desired level of detail took a substantial amount of work to develop. The specifics of the tax itself was most important. The state had existing tax statutes relating to penalties in AS.42.05 dealing with late payments for filing, negligence, and fraud. The division wanted to include penalties related to substantial understatement for individual taxpayers. There were several other administrative sections that other states utilized the division would like to "mimic." Representative Pruitt asked whether the penalties were the same or different than the penalties for other taxes the state currently administered. Mr. Spanos answered that the division incorporated the same penalties as the IRS in the state's corporate income tax statutes and noted the income tax would also incorporate the IRS penalties. He suggested that the penalty section in AS.42.05 could be applied to all tax types.

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Representative Pruitt asked about the departments' timeframe for offering amendments to the administrative sections. Mr. Spanos answered that the timeframe was the same as the members' amendment deadline. He thought that the timeframe was short and noted the division would include a few administrative provisions they deemed necessary. He mentioned the difficulty of proving fraud in income tax cases related to the inclusion of penalties for substantial understatement.

Co-Chair Foster interjected that amendments were due by 4:00 pm on Friday of the current week.

Representative Pruitt wondered whether the committee "should be moving a piece of legislation that did not have all of the pieces in it." Mr. Spanos thought that the bill was sufficient in its current form but expressed his desire for more administrative sections that made administering the tax simpler. Representative Pruitt believed that the committee process was responsible for including all necessary provisions in legislation.

HB 115 was HEARD and HELD in committee for further consideration.

Co-Chair Foster reviewed the agenda for the following day. Public testimony would be heard the following day.

ADJOURNMENT

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The meeting was adjourned at 2:30 p.m.