

SENATE FINANCE COMMITTEE
FOURTH SPECIAL SESSION
November 9, 2017
1:34 p.m.

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CALL TO ORDER

Co-Chair MacKinnon called the Senate Finance Committee meeting to order at 1:34 p.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Anna MacKinnon, Co-Chair
Senator Click Bishop, Vice-Chair
Senator Peter Micciche
Senator Donny Olson
Senator Gary Stevens
Senator Natasha von Imhof

MEMBERS ABSENT

None

ALSO PRESENT

Sheldon Fisher, Commissioner, Department of Revenue; Ken Alper, Director, Tax Division, Department of Revenue; Brandon S. Spanos, Deputy Director, Tax Division, Department of Revenue.

SUMMARY

SB 4001 EMPLOYMENT TAX

SB 4001 was HEARD and HELD in committee for further consideration.

#sb4001

SENATE BILL NO. 4001

"An Act imposing a tax on wages and net earnings from self-employment; relating to the administration and enforcement of the wages and net earnings from self-employment tax; and providing for an effective date."

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SHELDON FISHER, COMMISSIONER, DEPARTMENT OF REVENUE, introduced himself.

KEN ALPER, DIRECTOR, TAX DIVISION, DEPARTMENT OF REVENUE, introduced himself.

Co-Chair MacKinnon queried opening comments. Commissioner Fisher replied that he was grateful for the time allowed to discuss the bill. He announced that there was "too much uncertainty" in Alaska. He noted the budget deficit, and stressed that the deficit had an impact on the economy in the state. He stressed that there was an opportunity to unify the branches of government. He urged the committee to observe the presentation within the context of the current budget deficit. He stressed that he did not want to repeat the challenges of the most recent legislative sessions.

Co-Chair MacKinnon acknowledged that Co-Chair Hoffman, Senator Micciche, and herself had asked for an advancement of the new Department of Revenue (DOR) Sources Book. She wanted a common agreement that would reflect the revenue shortfall.

Mr. Alper acknowledged his staff who had worked to compose the preliminary fall forecast.

Co-Chair MacKinnon remarked that some of the items in the forecast may change, because of the pressure to provide the information early. She remarked that the changes would not be held against DOR, but stressed that she needed to know the reason for the change.

Mr. Alper remarked that chapter 3 of the Revenue Sources Book would be about oil price forecasting, and some of the nuance and uncertainty within that forecast.

Co-Chair MacKinnon noted the various models that predicted price at significantly higher than the DOR forecast.

Mr. Alper remarked that the presentation was like the presentation in the House Finance Committee, with some slight differences.

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Mr. Alper discussed the PowerPoint, "Capped Payroll Tax-Bill Introduction: SB 4001 by Governor Walker" (copy on file).

Mr. Alper looked at slide 2, "Bill Title":

"An Act imposing a tax on wages and net earnings from self-employment; relating to the administration and enforcement of the wages and net earnings from self-employment tax; and providing for an effective date."

Mr. Alper addressed slide 4, "From OMB Director Pitney." He remarked that expenditures had declined from the peak in 2013, but did not decrease as quickly as the revenues.

Mr. Alper highlighted slide 5, "The main issue is a reduction in oil revenue." He remarked that the slide reflected the decline in oil revenue. He also noted the decline in oil.

Mr. Alper addressed slide 6, "Budget has been reduced to 1990s levels when adjusted for inflation and population." He explained the colors of the chart.

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Mr. Alper discussed slide 7, "Why a Broad-Based Tax?"

- Even a small tax as proposed in SB4001 covers roughly half the forecasted ongoing deficits
- This buys the state time in case of various contingencies
- A tax combined with PF restructuring and continued budget discipline makes a complete fiscal plan
- If we get to where the CBRF is gone in a couple of years and don't have a revenue measure in place, it takes over a year to collect a new tax
- At that point, the remaining alternative of additional unstructured Earnings Reserve draw could establish a potentially catastrophic long-term precedent

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Senator von Imhof looked at the third bullet point, and queried the description of "continued budget discipline. Mr. Alper responded that he was only responsible for the Tax Division budget. He remarked that his division was consistently looking for consistencies. He hoped that every department and division was looking for efficiencies within their budgets.

Commissioner Fisher furthered that the budget proposals still left hundreds of millions of dollars of unfunded spending. He stressed that the tax would not fully fund the budget need, so it was incumbent to continue the focus on reducing costs. He stressed that a large driver was health care, and he hoped that there would be a conversation related to the handling of health care costs. He remarked that the Department of Administration (DOA) published a relevant article to that conversation. He understood that there was an expectation that there was a desire to see future budget discipline in the management and operation of government.

Co-Chair MacKinnon wondered whether Senator von Imhof wanted to elaborate on previous comments related to average inflation in the Anchorage area.

Senator von Imhof shared that David Teal [Director, Legislative Finance Division] had previously indicated that inflation at five-year trailing CPI [consumer price index] at approximately 1.3 percent yielded for a more balanced overall budget in the future years, than the assumptions of a higher growth rate. She stressed that the discipline was both in a starting point and future growth.

Commissioner Fisher remarked that felt that there was some wisdom in that assertion. He felt that there was a recent nationwide period of low inflation. He remarked that there was an expectation that future years would experience higher rates of inflation.

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Senator Micciche wondered whether the deficit was a likely temporary situation.

Commissioner Fisher stated that the modeling showed that in the out years the budget would go back into balance, and there would be a replenishment of the reserves.

Mr. Alper furthered that the balanced budget presumed the passage of a permanent fund restructuring bill, comparable to SB 26.

Mr. Alper addressed slide 8, "Impact of Unstructured Draws":

Maintaining the CBR balance at \$2 billion minimum level is crucial but leaves little flexibility.

An additional \$500 million annually taken from the ERA above the structured draw reduces the Permanent Fund balance by \$5 billion compared to a structured draw with additional revenues

That \$5 billion left in the PF generates \$250 million annually - reducing future tax.

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Co-Chair MacKinnon remarked that a \$2 billion draw would impact the long-term viability to the fund, and felt that a conversation of an additional \$500 million was a huge policy discussion. Mr. Alper agreed. He stated that the permanent fund tended to grow faster than the rate of inflation, because there was only a withdrawal of a portion of its earnings. He stressed that using the earnings to run government must allow for inflation within the structure to keep the real value whole.

Co-Chair MacKinnon felt that highlighting one variable in the discussion was not appropriate. She wanted to ensure that it was known that there were many variables that affected regions differently. The formula provided a different conclusion depending on "where we turn those knobs." She remarked that there had been a discussion about how one half of one percent equaled \$300 million. Mr. Alper replied that it equaled between \$200 million and \$300 million.

Co-Chair MacKinnon remarked that they were discussing rates that had historically been over 2 percent above the discussion. She pointed out that the three-year average was closer to 6.18 percent actual rate of return. She noted that there was a downward trend, in only the previous three years. Mr. Alper stated that the bill that had passed from

committee addressed the revisiting of the sustainable rates.

Senator Micciche wondered whether there was the right "mix in the liquidity management" statutes for the CBR. Mr. Alper replied that he did not fully understand the question. He stressed that the CBR was invested more aggressively when there was not the expectation to withdraw.

Senator Micciche felt that the time horizon of the five-year expected spend should be shortened, to have a higher rate of return on the CBR. Mr. Alper replied that the administration was directed by the legislature was that the portion that would not be needed in five years could be invested more aggressively at a higher rate of return. He expected that, should there be a broader fiscal solution passed, that there would be a transition into a better investment portfolio at a higher rate of return.

Commissioner Fisher furthered that five years was a long horizon, and shared that the statute that governed the management of the CBR required that money expected to be spent in five years be invested cautiously in highly liquid instruments. He felt that there should a reexamination of that management.

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Mr. Alper looked at slide 10, "Tax Proposal Summary":

- 1.5 percent tax on wages and self-employment income
- Tax paid by individuals earning income in Alaska; two income families would pay for each person
- Does not tax investments, retirement income, etc.
- Employers withhold and file for wage employees
- Tax is capped at \$2,200 or twice the previous year's PFD, whichever is greater
 - o Cap applies to incomes over \$147,000 / year
 - o Cap only impacts top 5 percent of earners
 - o Foregone revenue from the cap is \$10 to \$20 million

Mr. Alper discussed slide 11, "Tax Proposal Summary":

- Revenue about \$320 million at full implementation

- About 15 percent of revenue will come from nonresidents
- For most Alaskans the tax is less than the PFD
- Out-of-state residents will pay the highest effective rate because they do not receive PFDs

Senator Stevens queried the rationale for not letting those who earn more money pay more tax. Mr. Alper responded that there would be a slide related to the tax cap.

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Mr. Alper addressed slide 13, "Alaska History of Taxes based on Income and Wages":

- Began in 1949 at 10 percent of federal tax liability
- By 1961, the tax was 16 percent of federal tax liability
- In 1975, Alaska switched from federal tax liability to its own tax brackets
- Ranged from 3 percent to 14.5 percent on taxable income
- Alaska repealed personal income tax in 1980 after oil revenue boom
- "Alaska Fair Tax" (HB303) passed House in 2002. This was an income tax designed to match the effective tax rates of a Sales Tax
- Various bills 2015-17 leading to HB115

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Co-Chair MacKinnon queried the total amount of money that Alaskans pay in federal income taxes. Mr. Alper replied that it was more than \$300 million.

Co-Chair MacKinnon remarked that there was a notion that use of the earnings to benefit all Alaskans. She stated that 50 percent federal and general funds were the budget, which is why there was a concentration on the undesignated general funds (UGF). She stated that 50 percent of the UGF went to the communities, and were not part of the state government. She stressed that some people felt that it was unfair to take from low income families a dividend that meant something different than a higher income family. She stressed that Alaskans were contributing to federal taxes. Mr. Alper replied that the permanent fund was essential to Alaska's culture, both symbolically and monetarily.

2:13:14 PM

Co-Chair MacKinnon noted that a previous administration approved a "double dividend." Mr. Alper agreed. He remarked that there some slides that showed the per capita tax.

Mr. Alper discussed slide 14, "SB 4001 is different from a true income tax":

- Does not tax several key types of income:
 - Capital gains
 - Retirement earnings
 - S-corp distributions
- The administrative structure, as well as the flat rate with a cap, is modeled after the "school head tax" bills such as Sen. Bishop's SB12 (without the marginal tax issues that come with the stair step structure)
- Much less complex administration and staffing need
- Does not require individual filing for typical wage earners
- Nevada is one of seven states without any income tax, but has a Modified Business Tax (MBT) of 1.43 percent remitted by employers on wages above \$50,000 (Tax Foundation)

Mr. Alper highlighted slide 15, "Thought behind the 'cap'":

- Substantial number of Alaskans ask, in essence, "why are we collecting a tax with one agency while paying a dividend with another?"
 - Certain people, while opposing a tax, are prepared to give up their PFD to help operate government
- Actually eliminating the dividend would be very bad policy for many Alaskans throughout the state, and it is highly unlikely to imagine a majority approving a full elimination
- The structure of the SB 4001 "cap" acknowledges the concerns of those people- basically taxing the dividend back from higher income Alaskans
- The hope is, a tax with this structure will be more broadly acceptable than a full income tax

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Mr. Alper discussed slide 16, "Technical Language in SB 4001":

Bill is about 1/3 the length of HB 115.

Language is adequate to establish, or authorizes regulations to define, many key issues:

- Defining "self-employment" and "from a source in the state" plus other key terms
- Interpretations must be consistent with Multistate Tax Compact
- Incorporates IRS code to a limited degree where needed, state can require a copy of federal return
- Process for withholding and remitting tax by employers
- Filing of reports for payments to self-employed individuals and contract employees

Vice-Chair Bishop wondered if there had been analysis of the 1980 school head tax, and its implementation procedures. Mr. Alper replied that the proposal was withholding and employer-based, so there was some "piggybacking" that could be done with Department of Labor and Workforce Development (DLWD). He stated that the federal government funded some unemployment insurance, so the DLWD was federally funded with tightly prescribed workloads.

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Mr. Alper continued to discuss slide 16:

- Individual returns by those required to do so, mainly the self-employed
- Refunds for overpayment

Vice-Chair Bishop felt that the protocol already existed within DLWD, and there was a repayment method. Mr. Alper agreed. He stated that there was a cap that the state annually adjusted, which was currently \$39,000. He explained that unemployment insurance was only paid on the first number of dollars earned.

Mr. Alper looked at slide 18, "Revenue Impact":

- DOR estimates \$160 million in FY2019 due to the tax taking effect in January 2019
 - This amount is from withholding / employer payments
 - No tax returns filed until April 2020
- DOR estimates \$320 million in FY2020 based on modeling using aggregated federal income data for Alaska residents

Mr. Alper highlighted slide 19, "Revenue Details":

Revenue estimates are based on 2015 IRS Data

- About 440,000 total resident taxpayers, revenue \$280-\$290 million
 - 68,000 below \$10,000 income
 - 62,000 between \$10 and \$20,000
 - 161,000 between \$20 and \$50,000
 - 107,000 between \$50 and \$100,000
 - 38,000 between \$100 and \$250,000
 - 4,000 above \$250,000
- Net nonresident (after subtracting Alaskans who earn all their income outside) revenue \$40 million
- Without the cap, total revenue would be \$10 to \$20 million higher (foregone from high income individuals)

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Mr. Alper addressed slide 20, "Fiscal Note Implementation Cost":

- Implementing an individual income tax in 14 months will be a significant logistical challenge
 - o Need to draft regulations
 - o Need to design, develop, and test technology to administer tax system for over 400,000 taxpayers
- Estimated \$300,000 supplemental appropriation request for a contractor to work with DOR on an implementation plan
- Estimated \$10,000,000 one-time capital appropriation to build income tax into our current tax revenue system
 - o Includes withholding, filing, and refunds

- Gradual ramp-up of staffing; eventual annual management cost estimate is \$5.2 million with up to 40 employees
- Total cost over six-year fiscal note period is about 2.5 percent of projected revenue.

Co-Chair MacKinnon queried a comparison to the income tax that was proposed, and the employees needed for income tax; versus the payroll tax with most of the collections housed in other areas outside of state government. Mr. Alper replied that the income tax fiscal note spoke of 60 employees, but he felt that was too few a number. He remarked that the type of auditing activity with an income tax was "a big deal." He stated that there could probably be one-half of the numbers of additional employees. He stated that the cap would save money, because there was less need to audit the high-income tax payer to be sure that they were filing accurately.

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Senator von Imhof wondered whether the component could be added to the personal business. Mr. Alper replied that there would be efficiencies, and felt that the main comingling element with the Permanent Fund Division would be dealing with the physical paper application.

Senator von Imhof noted that there was already a quarterly report of employees by the employer. She felt that there would be a redundancy of work. Mr. Alper replied that there was a hope to use the DLWD data.

Mr. Alper discussed slide 21, "Fiscal Note Implementation Cost":

- The Department of Revenue's Fiscal Note is somewhat conservative (meaning too high, we hope)
- Assumes stand-alone system built within the Tax Division
- Items that need to be pinned down (partial list):
 - How much can we limit individual reporting needs vs. relying on employer filing?
 - Process for self-employment filing system
 - Degree of electronic vs. paper filing
 - Potential coordination with Department of Labor (Employment Security Tax). This would have substantial challenges due to federal funding

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Co-Chair MacKinnon announced that the presentation was currently on slide 21.

Mr. Alper highlighted slide 23, "Impact of Recession on Alaska's Economy":

Per the Alaska Department of Labor, since the peak:

- Overall economic activity in the state down 17 percent (much of this due to the reduction in the value of every barrel of oil)
- Total job losses 11,600 positions (3.2 percent)
- State government job losses 2,600 positions (11 percent)
- State facility closures throughout the state

Vice-Chair Bishop wondered whether the 2600 state job losses were "real people affected by a layoff." Commissioner Fisher explained the difference between layoffs, reductions, and vacant PCNs [position control numbers]. He explained that there were several PCNs that were not funded. He stated that the slide represented people that were receiving a paycheck, and were currently not receiving a paycheck. He explained that the majority were association with attrition that were not backfilled.

Mr. Alper furthered that eliminating a state position would cause that person in that position to look for another job.

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Co-Chair MacKinnon wondered whether the private sector used attrition as the best business practice when facing a large deficit. Commissioner Fisher responded in the affirmative.

Co-Chair MacKinnon stated that the 2600 employees might need state services. Commissioner Fisher agreed.

Vice-Chair Bishop stressed that he would like to see full employment.

Co-Chair MacKinnon noted that Alaska had the highest unemployment rate at 9 percent.

Mr. Alper addressed slide 24, "ISER-Job Impact of Different Options." He noted that taking the money out of the economy would be reflected in job losses.

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Co-Chair MacKinnon queried the label on the lighter area of the slide. Mr. Alper replied that there was enough uncertainty and variables in the analysis, based on certain assumptions.

Co-Chair MacKinnon handed the gavel to Co-Chair Hoffman.

Mr. Alper looked at slide 25, "ITEP analyzed multiple tax options that each would raise \$500 million." He stated that the slide was a screenshot from the Institute for Taxation and Economic Policy.

Mr. Alper highlighted slide 26, "Comparable Tax Burden (state to state)." The chart showed the per capita taxation of every state.

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Senator von Imhof queried the other states with regional sales tax layered with their state sales tax. Mr. Alper shared that the next slide might address that issue. He stated that Alaska was unusual in that it had predominantly local sales taxes. He remarked that the actual average sales tax rate paid by Alaskans was 1.7 percent, but no one actual paid that rate, but it was the average of all the 107 sales taxes in the state. He shared that other states had local taxes, but "piggy-banked" on top of the state sales tax.

Co-Chair Hoffman handed the gavel to Co-Chair MacKinnon.

Senator von Imhof stressed that Alaska had a tax related to health care. She felt that the cost of living in Alaska was extremely high. Mr. Alper agreed.

Mr. Alper discussed slide 27, "Comparable Tax Burden (state and local)."

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Senator Micciche wondered why the oil and gas property tax was included, because he felt that it was a confusing addition to the slide. Mr. Alper replied that the property tax data included all local property taxes.

Co-Chair MacKinnon noted that the contribution to school districts was based from a calculation on property tax. She remarked that a reduction in property tax would be a loss to the local schools. Mr. Alper replied that it was included in the property tax data set.

Mr. Alper highlighted slide 28, "Comparable Tax Burden (largest cities.)"

Co-Chair MacKinnon wondered whether there could be a walk-through of the structure of the bill. Mr. Alper replied in the affirmative.

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Mr. Alper deferred to Mr. Spanos.

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BRANDON S. SPANOS, DEPUTY DIRECTOR, TAX DIVISION, DEPARTMENT OF REVENUE, discussed the Sectional Analysis (copy on file):

Section 1:

Conforming language to exempt individuals required to file under this bill from electronic filing requirement. Actual exemption language is in Section 2 at 43.45.051(f).

Section 2:

Adds a new chapter 45 in AS 43 for a payroll tax on both wages and self-employment income earned in Alaska.

43.45.011 - Imposes a tax of 1.5 percent on wages and net earnings from self-employment from sources in the state. Net operating losses are not allowed when calculating earnings from self-

employment. Creates a maximum tax "cap" equal to two times the permanent fund dividend distributed in the previous calendar year. If the dividend is less than \$1,100 as adjusted for inflation, the maximum tax is \$2,200 adjusted for inflation instead.

43.45.021 - Defines sources of income in Alaska that are subject to the tax.

Senator Stevens asked that there be a reference to a page and a line.

Mr. Spanos continued to discuss the Sectional Analysis:

43.45.031 - Authorizes the DOR to adopt regulations for determining self-employment and partnership net income of multistate businesses consistent with apportionment statutes currently allowed for multistate corporations.

Co-Chair MacKinnon announced that she would point out the pages.

Mr. Alper stated that the bulk of the bill was in Section 2, which added new statute that created the new tax.

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Mr. Spanos continued to discuss the Sectional Analysis:

43.45.041 - Provides for withholding from wages and salaries by employers, with those withheld taxes periodically remitted to the state.

43.45.051 - Provides for annual returns from self-employed individuals to the DOR with taxes due on the date the federal tax return is due. Self-employed individuals are exempt from the requirement to file a return electronically, but paid preparers are not exempt from the requirement. Authorizes the DOR to adopt regulations for partnerships to elect to pay tax on the partner's behalf and file composite tax returns.

43.45.061 - Provides that a taxpayer's tax year and method of accounting are the same as they are for federal tax purposes.

43.45.071 - The department is authorized to pay refunds of overpaid taxes. Refunds may be coordinated with refunds of employment security contributions.

43.45.081 - Anyone required federally to report a payment to a self-employed individual is required to report the same payment to the DOR.

43.45.091 - Authorizes the DOR to adopt regulations and forms. Tax collected under this bill to be deposited into the general fund. The DOR will coordinate collection and reporting of this tax with the employment security contributions by the DLWD if it will result in cost savings for the state.

43.45.101 - Adopts certain administrative and penalty sections of the internal revenue code.

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Co-Chair MacKinnon wondered whether the references did not commit Alaskans to any other form of taxation outside of the control, based on the legislation that tied into the federal code. She wondered whether it was for refunds only or descriptive language that was consistent with employment issues. She asked whether the legislation "hooked into" a rate increase or something else. Mr. Spanos replied that there were no rate increases in the sections. He stated that there may be some understatement penalties.

Co-Chair MacKinnon remarked that there may be some changes that had increased compliance requirements. Mr. Spanos stated that the sections were all administrative sections.

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Mr. Spanos continued to discuss the Sectional Analysis:

43.45.111 - Authorizes the DOR to send certain confidential information to a banking institution

to verify the direct deposit or correct an error of a refund.

43.45.151 - Adds definitions for specific terms used in this section.

Section 3:

The DOR may adopt regulations to implement Section 2. The regulations will take effect on or after the effective date of Section 2.

Section 4:

Immediate effective date of Section 3, so that regulations can be drafted immediately.

Section 5:

Effective date of 1/1/2019 for the rest of the bill.

Mr. Alper thanked the committee for their consideration of the bill.

Co-Chair MacKinnon thanked the presenters. She remarked that many Alaskans had opinions about the subjects discussed related to the bill and the budget. She wished Senator Giessel a "Happy Birthday." She felt that Senator Giessel was one of the most hardworking legislators. She discussed the following day's agenda.

SB 4001 was HEARD and HELD in committee for further consideration.

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ADJOURNMENT

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The meeting was adjourned at 3:27 p.m.