

ALASKA STATE LEGISLATURE
SENATE LABOR AND COMMERCE STANDING COMMITTEE

April 27, 2017

1:32 p.m.

MEMBERS PRESENT

Senator Mia Costello, Chair
Senator Shelley Hughes, Vice Chair
Senator Kevin Meyer
Senator Gary Stevens
Senator Berta Gardner

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

COMMITTEE SUBSTITUTE FOR HOUSE BILL NO. 115(FIN) AM(EFD FLD)
"An Act bearing the short title of the 'Education Funding Act'; relating to the taxation of income of individuals, partners, shareholders in S corporations, trusts, and estates; relating to a payment against the individual income tax from the permanent fund dividend disbursement; and repealing tax credits applied against the tax on individuals under the Alaska Net Income Tax Act."

- HEARD AND HELD

PREVIOUS COMMITTEE ACTION

BILL: HB 115

SHORT TITLE: INCOME TAX; PFD PAYMENT/CREDIT;

SPONSOR(S): FINANCE

02/10/17	(H)	READ THE FIRST TIME - REFERRALS
02/10/17	(H)	FIN
02/13/17	(H)	FIN AT 1:30 PM HOUSE FINANCE 519
02/13/17	(H)	Heard & Held
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 04/07/17 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 04/07/17 (H) <Bill Hearing Canceled>
 04/11/17 (H) FIN AT 1:30 PM HOUSE FINANCE 519
 04/11/17 (H) Moved CSHB 115(FIN) Out of Committee
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 04/12/17 (H) DP: GUTTENBERG, GARA, SEATON, FOSTER
 04/12/17 (H) DNP: TILTON, THOMPSON, PRUITT, WILSON
 04/12/17 (H) NR: GRENN, ORTIZ
 04/12/17 (H) AM: KAWASAKI
 04/15/17 (H) BEFORE HOUSE IN SECOND READING
 04/16/17 (H) TRANSMITTED TO (S)
 04/16/17 (H) VERSION: CSHB 115(FIN) AM(EFD FLD)
 04/17/17 (S) READ THE FIRST TIME - REFERRALS
 04/17/17 (S) L&C, FIN
 04/24/17 (S) L&C AT 1:30 PM BELTZ 105 (TSBldg)
 04/24/17 (S) -- MEETING CANCELED --
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WITNESS REGISTER

ADAM MILLSAP, PhD
 Mercatus Center
 George Mason University
 Arlington, Virginia

POSITION STATEMENT: During the hearing on HB 115, presented a letter titled "Recommendations for Tax Reform in Alaska."

MATT BLATTMACHR, Vice President and Trust Officer
Peak Trust Company
Anchorage, Alaska

POSITION STATEMENT: During the hearing on HB 115, delivered a PowerPoint titled "Income Taxation of Estates, Trusts and Their Beneficiaries."

ACTION NARRATIVE

[1:32:13 PM](#)

CHAIR MIA COSTELLO called the Senate Labor and Commerce Standing Committee meeting to order at 1:32 p.m. Present at the call to order were Senators Gardner, Stevens, Meyer, Hughes, and Chair Costello. Senator Giessel was also in attendance.

HB 115-INCOME TAX; PFD PAYMENT/CREDIT

CHAIR COSTELLO announced the consideration of HB 115. She asked Mr. Millsap to start his presentation by telling the committee about the Mercatus Center.

[1:34:00 PM](#)

ADAM MILLSAP, PhD, Mercatus Center, George Mason University, Arlington, Virginia, stated that the Mercatus Center is a university-based research center whose mission is to bridge the gap between academic ideas and policy by sharing research with policymakers. He said he couldn't give details about funding because the research center is entirely separate, but the donor policy is on the website. It includes contact names and numbers if anyone is interested in more information.

[1:35:14 PM](#)

MR. MILLSAP read the following testimony into the record:

Chairman Costello, Vice Chairman Hughes, and distinguished members of the Senate Labor and Commerce Committee:

Thank you for accepting my testimony on creating an alternative source of revenue in Alaska and on the features of economically sound tax policy. My name is Adam Millsap, and I am a research fellow at the Mercatus Center at George Mason University, where I study state and local public policy. As Alaska's legislature considers alternative revenue sources, my message today is that tax policy that is economically efficient and promotes economic growth has two

important features: 1) low rates and 2) a broad tax base with few exemptions or deductions.¹

TAX REFORM IN ALASKA

The most common sources of revenue for state governments are the income tax and the sales tax. Alaska has neither of these, instead relying on taxes, rents, and royalties tied to the extraction of oil and gas for much of its revenue. The price and production of these commodities fluctuates for a variety of supply and demand reasons, and Alaska's reliance on them as a source of revenue results in some of that volatility being transferred to the state's revenue stream.

In recent years Alaska has experienced significant budget deficits, which has generated a search for more stable alternative sources of revenue. An income tax, a sales tax, or a combination of the two is capable of providing that revenue. However, the efficacy and efficiency of any tax depends on the way it is structured. For a tax to generate revenue efficiently, it should consist of low rates and a broad base.

In combination, these features reduce the number of tax-related distortions to the economy and maximize the amount of resources left in the hands of taxpayers, while still raising adequate revenue for government functions. They also reduce compliance costs, which are the costs associated with obeying the law. Reducing the number of deductions and exemptions saves time and effort required to ensure compliance.

A simple tax code also means less effort needs to be expended monitoring year-to-year changes in brackets and allowable deductions and exemptions. Finally, a broad tax base is generally less variable over time, which makes it easier for policymakers to forecast revenue during the budgeting process.²

STRUCTURE INCOME TAX TO AVOID DISTORTIONS

As mentioned previously, two common state taxes are the income tax and the sales tax. Income taxes distort people's choices of how much to work by reducing the benefits of work. Low marginal income tax rates reduce this distortion. Limiting deductions and exemptions also allows rates to be lower by broadening the tax base.

Numerous income tax brackets increase the complexity of the tax code and deter additional work near each

bracket threshold, since any additional income is subject to a higher tax rate than previous income. The more brackets there are, the more often workers confront changes in the incentive to work. Reducing the number of brackets encourages more work across the income distribution. Some progressivity in the tax code may be desirable, but it should be achieved with as few brackets as possible.

States have implemented income taxes at different times, and there is evidence that states experience slower per capita income growth following the adoption of an income tax.³ This is consistent with other studies that find that states with higher income tax rates experience slower per capita income growth.⁴ There is also evidence that people migrate in order to reduce their tax liability.⁵ Thus the creation of an income tax may harm Alaska's economy by reducing the incentive to work and by inducing people to emigrate from the state.

However, the potential costs to economic growth from the implementation of an income tax must be weighed against the costs of chronic budget deficits and spending cuts. For example, some studies find that government spending on education, public health, and infrastructure can counteract the disincentive effects of greater taxation and actually improve economic growth.⁶ And since people and businesses are forward looking, large and frequent budget deficits will cause them to expect future tax increases and will create uncertainty about the state's economic and fiscal future.

The net effect on Alaska's economy will ultimately depend on the structure of the income tax, the state's spending decisions, and whether an income tax can assure residents, investors, and firms that the state's finances are sound.

Many states have reformed their income tax codes recently, and these reforms provide some guidance for Alaska.⁷ Reforms in Utah and North Carolina broadened their income tax bases by eliminating various credits, exemptions, and deductions and replaced their systems of tax brackets with one flat rate. These changes eliminated distortions in the tax code and improved the efficiency of each state's income tax. Alaska can eliminate the need for future reform by implementing an income tax with similar features from the start.

STRUCTURE SALES TAX TO LIMIT DISTORTIONS AND REGRESSIVENESS

In addition to the income tax, a sales tax is a common way for government to raise revenue. A sales tax is a tax on consumption, so it discourages consumption and encourages saving. More saving means more investment and ultimately more economic growth. Conversely, the income tax's main flaw is that it discourages work and saving. This is why many economists prefer a comprehensive consumption tax over an income tax as a means of generating revenue.

However, a sales tax also has drawbacks, the primary one being that in its most common and basic form it is regressive. Since lower-income people spend a larger portion of their income than higher-income people, a sales tax imposes a relatively larger burden on those with lower incomes. This undesirable feature can be mitigated by applying the sales tax to a broad base that includes both goods and services. Taxing services is also important since unlike in the past, most consumer spending today is on services rather than goods.

Applying a sales tax to all final goods and services allows the rate to be lower to achieve a given revenue target, which reduces the burden on all consumers.⁸ A broad base can also reduce the tax's regressiveness, since higher-income people spend a larger share of their income on services than lower-income people.⁹ If only goods are taxed, a sizeable amount of consumer spending, especially by higher-income people, will be unfairly exempt from taxation.

Product-specific sales taxes, commonly referred to as "sin taxes," are especially egregious since they are routinely applied to goods disproportionately consumed by lower-income people. The limited scope of sin taxes creates large welfare losses as consumers expend time and effort seeking out tax-free alternatives.¹⁰ They also invite lobbying from various interests, both for and against the taxes, which wastes resources in a process called rent-seeking.¹¹ Product-specific or industry-specific sales taxes should be avoided for these reasons.

MAKE THE TAX CODE MORE EQUITABLE

Equity is another important feature of tax policy that could be improved in Alaska. Horizontal equity is achieved when taxpayers who earn the same income face the same tax burden. In Alaska, revenue is primarily raised through the oil and gas industry. In fiscal

year 2016, oil and gas revenue accounted for 72 percent of the state's general fund unrestricted revenue.¹²

Since all taxes are ultimately paid by people, taxes on the oil and gas industry are paid by some combination of its workers, owners, and customers. This means that workers and investors in this industry bear more of the tax burden in the form of lower wages and dividends than similar people in other industries, which violates the principle of horizontal equity.

Moreover, the benefit principle of taxation states that those receiving the benefits of government goods and services should contribute to their provision. While Alaska does levy some user fees, product-specific sales taxes, and a corporate income tax, these taxes generate significantly less revenue than the taxes on the oil and gas industry. To the extent that Alaska's state government is providing goods and services that benefit each resident, each resident should contribute to their cost. A broad-based income or sales tax would be more equitable, and it would better satisfy the benefit principle of taxation than the current system, since it would more evenly distribute the cost of government.

CONCLUSION

Efficient and effective tax policy should consist of low rates that are applied to broad bases. Together, low rates and a broad base reduce distortions, decrease compliance costs and ensure that the tax burden is shared equitably by all taxpayers.

Finally, it is important to note that the creation of an income tax, sales tax, or both should not be viewed as a panacea. Such taxes can provide a relatively stable source of additional revenue, but it is also important for state governments and their citizenry to live within their means. Government spending in Alaska as a percentage of total state personal income was 31 percent in 2015, nearly two and a half times the national average of 13 percent.¹³ Maintaining such a high level of spending relative to income would likely require more than a modest tax increase, and higher tax rates increase the likelihood that an income or sales tax will have a negative net effect on Alaska's economy. For this reason, efforts to balance Alaska's budget should consider both revenue increases and spending cuts.

Thank you for inviting me to speak with you today about tax policy in Alaska. I look forward to answering any questions you may have concerning my testimony.

¹ Adam Millsap and Olivia Gonzalez, "State and Local Tax Policy," *Economic Perspectives*, Mercatus Center at George Mason University, January 2016.

² Richard F. Dye and Therese J. McGuire, "Growth and Variability of State Individual Income and General Sales Taxes," *National Tax Journal* (1991): 55-66.

³ Thomas R. Dye and Richard C. Feiock, "State Income Tax Adoption and Economic Growth," *Social Science Quarterly* (1995): 648-54.

⁴ Barry W. Poulson and Jules Gordon Kaplan, "State Income Taxes and Economic Growth," *Cato Journal* 28, no. 1 (2008): 53.

Randall G. Holcombe and Donald J. Lacombe, "The Effect of State Income Taxation on Per Capita Income Growth," *Public Finance Review* 32, no. 3 (2004): 292-312.

⁵ Ira S. Saltz, "State Income Tax Policy and Geographic Labour Force Mobility in the United States," *Applied Economics Letters*

5, no. 10 (1998): 599-601. Martin Feldstein and Marian Vaillant Wrobel, "Can State Taxes Redistribute Income?," *Journal of Public Economics* 68, no. 3 (1998): 369-96. Richard J. Cebula and Gigi M. Alexander, "Determinants of Net Interstate Migration, 2000-2004," *Journal of Regional Analysis and Policy* 36, no. 2 (2006): 116-23.

⁶ L. Jay Helms, "The Effect of State and Local Taxes on Economic Growth: A Time Series-Cross Section Approach," *Review of Economics and Statistics* 67, no. 4 (1985): 574-82. Alaeddin Mofidi and Joe A. Stone, "Do State and Local Taxes Affect Economic Growth?," *Review of Economics and Statistics* (1990): 686-91.

⁷ George R. Crowley, "Case Studies in the Political Economy of Tax Reform" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2016)

⁸ Thomas Stratmann, "More Sales Tax Exemptions, Higher Sales Tax Rates," Mercatus Center at George Mason University, September 17, 2014.

⁹ John J. Siegfried and Paul A. Smith, "The Distributional Effects of a Sales Tax on Services," *National Tax Journal* 44, no. 1 (1991): 41-53.

¹⁰ Adam J. Hoffer, William F. Shughart, and Michael D. Thomas, "Sin Taxes and Sindustry: Revenue, Paternalism, and Political Interest," *Independent Review* 19, no. 1 (2014): 47-64.

¹¹ Richard Williams and Katelyn Christ, "Taxing Sin" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, July 2009).

¹² Alaska Department of Revenue, Tax Division, "Revenue Sources Book: Fall 2016," accessed April 26, 2017.

¹³ Eileen Norcross and Olivia Gonzalez, "Ranking the States by Fiscal Condition: 2017 Edition" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, forthcoming).

[1:44:34 PM](#)

SENATOR STEVENS asked him to elaborate on the statement that sin taxes apply disproportionately to lower-income people.

MR. MILLSAP explained that sin taxes are generally applied as a way of deterring behavior, not as a means of generating revenue. They apply to things like tobacco products, alcohol, and junk food and a higher proportion of lower-income people tend to consume of these products.

SENATOR STEVENS disagreed with the premise but declined to ask additional questions.

SENATOR GARDNER commented that while it's true that some segments of society may drink a lot more beer, higher-income people probably pay more for the alcohol they drink.

She referenced the statement that taxes on the oil and gas industry are paid by some combination of the workers, owners, and customers. In Alaska, taxes on the oil industry comes from a variety of sources, including severance or production tax. That can be thought of as the sales price for the resource that Alaskans own in common. She asked if that changes the calculation of horizontal equity.

MR. MILLSAP replied there might be a slight difference, but it's not so large that the people involved in the industry are bearing a higher portion of the tax burden.

[1:49:14 PM](#)

SENATOR MEYER asked if it's logical to think that initiating an income tax will cause people to move where the cost of living is lower, even though they may have to pay income tax or sales tax or both in that new location.

MR. MILLSAP said it's perfectly reasonable to think that some people may be living in Alaska because it is a lower tax environment, and any decision the legislature makes to increase revenue is going to change that calculus. It may provide an additional reason to migrate to another state.

SENATOR MEYER referenced the statements that states experience slower per capita growth after implementing an income tax, and that people migrate to reduce their tax liability.

MR. MILLSAP confirmed that was part of his testimony.

[1:52:36 PM](#)

SENATOR HUGHES asked if the introduction of an income tax coupled with the high cost of living in Alaska would likely result in higher outmigration compared to other states.

MR. MILLSAP opined that the introduction of an income tax would change some people's decision making, but whether the numbers are higher or lower than any other state that introduces such a tax would depend, in part, on the tax rate. The magnitude of the outmigration is an empirical question that can only be evaluated ex-post, he said, but putting the money to productive services such as improving education, public health, or worthwhile infrastructure that helps the economy could be an offset.

SENATOR HUGHES referenced his testimony that 2015 government spending in Alaska was 31 percent of total state personal income, and the suggestion that the state should consider both revenue increases and spending cuts. She asked if other states had faced a similar situation and questioned whether any reductions would be made if an income tax was introduced first.

MR. MILLSAP said he would advise doing them simultaneously because the additional revenue could readily be spent without addressing spending. That is what happened when Connecticut implemented an individual income tax in the early 1990s. Spending cuts were not made at the same time that the tax was implemented, and that state is currently dealing with both budget and pension issues.

SENATOR HUGHES asked if it wouldn't be better to make cuts first.

MR. MILLSAP said he assumes the budget process would have cuts and new revenue done somewhat in tandem. He cautioned against raising revenue first and delaying spending cuts.

[1:59:13 PM](#)

SENATOR GARDNER asked him to compare the scenarios of taking definitive action to raise revenue through new taxes versus not doing so, given Alaska's specific situation. That includes: an operating budget that has been cut by 26 percent in recent years; a credit rating that is dropping and at risk of dropping further; a well-demonstrated reluctance of industry, individuals, and small businesses to make investments due to a lack of confidence in the fiscal future; a struggling university; no community college system in a society where more and more people need to have more than a high school education; and school districts that are laying off hundreds of teachers and increasing class sizes.

MR. MILLSAP said it's an excellent point because both revenue and spending needs to be considered. Cutting core government services that people have come to expect is not the best way to make Alaska a good place to live and do business. If there is very little room for significant cuts, the revenue side needs to be shored up. He said this is ultimately a question for Alaska taxpayers, but he does believe that running huge budget deficits is a concern. People who are considering moving to or doing business in Alaska are going to take this into consideration.

[2:02:39 PM](#)

CHAIR COSTELLO asked how the introduction of an income tax would affect the unemployment rate and the cost of living in Alaska.

MR. MILLSAP said an income tax will certainly reduce people's disposable income. However, it's a valid concern that the most recent employment figures indicate that jobs are either leaving the state or not being created as fast as they're destroyed. He advised that most states that implement an income tax do so during an economic boom. Alaska would be somewhat unique if it were to implement a tax when the economy is struggling. If the decision is to implement an income tax, he suggested policymakers remain flexible and willing to go back and make changes if necessary.

CHAIR COSTELLO asked if it's good or bad timing to implement an income tax while the economy is in a recession.

MR. MILLSAP replied the timing is not optimal because it would pull money out of the economy. Nevertheless, Alaska must deal with the budget deficit and its hand might be forced. He reiterated his advice to policymakers to remain flexible.

CHAIR COSTELLO asked how HB 115 would affect seniors and military families.

MR. MILLSAP asked if she is asking if retirement income should not be taxed.

CHAIR COSTELLO said that's correct. The bill has a standard deduction for each individual, but it has no other deductions.

MR. MILLSAP said that's the most efficient thing to do from an economic standpoint. A broader base keeps the rates as low as possible and is the least distortive. He advised to keep the current design with few deductions and exemptions and apply the tax rate to all income earned in the state.

CHAIR COSTELLO asked if S corporations and small businesses will be impacted by the current tax proposal.

MR. MILLSAP said they should be affected like everyone else. A small business owner who files under the personal income tax should pay the rate.

CHAIR COSTELLO asked if other states that are struggling with budget deficits have savings like Alaska has.

MR. MILLSAP said some states have rainy-day funds and he isn't opposed to using them to help with budget deficits, but Alaska's budget deficits are more a structural problem based on the oil market. It's reasonable to pull money from savings when it's needed, but in Alaska's case that's not a substitution for structural reform.

[2:10:00 PM](#)

SENATOR STEVENS asked for an explanation of the statement that an income tax may harm the economy by reducing the incentive to work. He said it seems that an income tax would increase the incentive to work.

MR. MILLSAP answered with an explanation of the substitution effect. In the context of an income tax, it's an economic understanding that an individual will replace working a little more with taking some leisure - not working. There is also an income effect. In the context of an income tax, that's the economic understanding that the tax makes an individual feel poorer and it induces them to work more. The question is which effect dominates. When economists look at the entire economy they see that the substitution effect tends to dominate the income effect. The reason at the macro level is that not only can people choose to work a little bit less, but they can also choose not to work at all. For example, a second earner in a home may choose to work if there isn't an income tax, but when the income tax is implemented they may choose not to work.

[2:12:37 PM](#)

SENATOR HUGHES asked if initiating an income tax right now might deepen and prolong the recession.

MR. MILLSAP said economists don't generally think that initiating an income tax will help to get out of a recession, but it might not hurt given Alaska's existing deficit and the potential magnitude of spending cuts that might have to occur without an additional revenue stream.

SENATOR HUGHES asked if he had reviewed HB 115 and his thoughts on the tax brackets that are proposed.

MR. MILLSAP said he reviewed the bill and believes it's inefficient to have five brackets in such a short range.

[2:15:48 PM](#)

SENATOR HUGHES asked if a sales tax would be less regressive if groceries were excluded.

MR. MILLSAP said yes.

SENATOR HUGHES highlighted the unique situation in many Alaska village where groceries are very expensive.

[2:17:26 PM](#)

SENATOR GARDNER asked if instituting an income tax and initiating large budget cuts impact employment rates equally.

MR. MILLSAP said it's hard to tell which would be worse, but it comes down to what is cut. Massive spending cuts that eliminate core services and delay infrastructure maintenance probably have a similar impact to implementing an income tax on employment.

SENATOR GARDNER asked, other than cutting taxes, what the state could do to stimulate the economy in the current recession and do away with uncertainty.

MR. MILLSAP said recessions often need to run their course, but it might help if the state could lend certainty to outside investors whether that's bondholders or people thinking about moving to Alaska or businesses thinking about opening in Alaska. He warned that trying too hard to pull out of a recession can make things worse down the road.

[2:21:32 PM](#)

SENATOR GARDNER asked if he's aware that the state has cut its operating budget by 26 percent and has been operating with essentially no capital budget for the last several years. That has impacted a lot of employees, particularly in the trades.

She asked if there have been any studies about how people weigh the non-financial factors when they determine where to live. An income tax will hurt, but Alaskans place a lot of value on clean air and water, hunting and fishing, and wide-open spaces.

MR. MILLSAP agreed that some people will stay in Alaska regardless of an income tax. It has things they can't get anywhere else. The people who would leave are those who are on the margin. They moved to Alaska for a reason when there was no income tax and instituting one changes their decision making enough that it makes sense to go somewhere else. He acknowledged that Alaska could be unique, and a tax would have a smaller

effect on the decision to leave. Nevertheless, some people will leave.

[2:24:15 PM](#)

CHAIR COSTELLO asked him to comment on the impact of President Trump's recent tax proposal that removes the deduction for state taxes.

MR. MILLSAP said the deduction is only available to people who itemize, and he didn't know how many Alaskans that might include. He also wondered about the chance of that proposal getting through the process.

[2:26:03 PM](#)

CHAIR COSTELLO thanked Mr. Millsap.

[2:26:32 PM](#)

At ease

[2:30:23 PM](#)

CHAIR COSTELLO reconvened the meeting and welcomed Mr. Blattmachr.

[2:30:47 PM](#)

MATT BLATTMACHR, Vice President and Trust Officer, Peak Trust Company, Anchorage, said he is "more or less" representing the trust and estate planning industry in Alaska. He informed the committee that in 1997 the legislature passed the Alaska Trust Act. This made Alaska the first state in the nation to allow self-settled trusts and perpetual trusts. Since then, the legislature has passed additional laws that has kept Alaska at the forefront of the industry. The industry has been so successful that many other states have tried to compete for this business. The state has benefited greatly over the years and it generates meaningful tax revenue. The insurance tax currently brings over \$7 million into the general fund each year.

He related that the goal of the presentation is to highlight the benefits of the trust industry to the state and to offer evidence that to maintain the industry, some provisions in HB 115 need to be reexamined.

MR. BLATTMACHR explained that trusts are generally used by average Alaskans for family and estate planning. He advised that the considerable discussion about the taxation of trusts during the bill hearings is just a minor piece in the overall scope of trusts. He explained that trusts are usually taxed in one of

three ways: to the grantor, to the beneficiary, or to the trust itself. The grantor (trust creator) is taxed if they retain sufficient interest. Many trusts are taxed this way because of the benefits associated with grantor trust status. The beneficiary is taxed to the extent that he or she receives distributions of income from the trust. The trust itself is taxed if income is retained by the trust and it is not a grantor trust.

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MR. BLATTMACHR said there are many different types of trusts, but they can be broadly divided into revocable and irrevocable trusts. Revocable trusts are essentially a will substitute that has no tax advantages whatsoever. The income is taxed to the individual that creates the trust. Irrevocable trusts create separate and distinct entities. Taxation depends on whether the trust has grantor status, whether there have been distributions, and under HB 115 whether it would qualify as a resident or nonresident trust for state income taxes.

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He reiterated that a trust can be considered a grantor if the person who created the trust retains certain interests. This includes: the grantor is a beneficiary, their spouse is a beneficiary, they have the power to control beneficial enjoyment, the trust has reversionary interests that can come back to the grantor, or if the income from the trust can be used for the benefit of the grantor. If the grantor retains sufficient control, he or she is taxed on the trust income.

Irrevocable trusts can be grantor or non-grantor. Both are broken out for resident and nonresident for state tax purposes. He related that prior discussions on HB 115 centered on irrevocable trusts, particularly non-grantor resident and nonresident trusts where the income is accumulated. For grantor trusts, income is taxed to the grantor. Non-grantor trusts are those where the trust is its own taxpaying entity. Income will be taxed to the beneficiary, to the extent that income is distributed. It will be taxed to the trust when the income is retained. If the income is split between the beneficiary and the trust, each pays the appropriate share of the tax. He reported that all competitive states in this industry try to tax resident trusts if there is a state income tax. Nonresident trusts are not taxed because doing so would eliminate any nonresident business.

MR. BLATTMACHR reviewed several scenarios, all of which assume no Alaska income. The first scenario is an Alaska resident who creates a grantor trust. Whether income is accumulated or distributed, it flows through to the grantor's Form 1040. If there is a state income tax, the state would always collect the proper tax on that trust. The second scenario is a grantor trust created by a nonresident. Regardless of whether the income is accumulated or distributed, it is taxed to the nonresident. He advised that in this scenario Alaska should not attempt to collect tax on the income from the trust. Doing so is potentially unconstitutional, especially if there isn't any Alaska-source income, and it would likely kill Alaska's trust industry.

Scenario three is non-grantor trust created by nonresidents. If income is accumulated, the trust would pay its own federal tax. If the income is distributed to an Alaskan beneficiary, it would be included in the beneficiary's taxable income and the state would collect the state income tax. If the income is distributed to a nonresident beneficiary, they would not pay Alaska income tax. He reiterated that this assumes that there is no Alaska-source income. Scenario four is a non-grantor trust by an Alaska resident. Under HB 115 resident beneficiaries would be subject to the state income tax if there was a distribution, but nonresidents would not.

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MR. BLATTMACHR stated that that if HB 115 were to pass, Alaskans who establish non-grantor trusts with resident and nonresident beneficiaries would be encouraged to do their trust planning in another state. He said it's a policy call as to whether Alaska is open for trust business for just nonresidents.

He turned to the federal tax rates on trusts stating that federal taxes discourage income retention and encourage distributions from the trust. Trusts have the same tax brackets as individuals, but they're compressed. For example, individuals reach the maximum 43.4 percent tax bracket, including the Medicare surtax, at \$415,050 for single filers and \$466,950 for married joint filers. A trust reaches the maximum 43.4 percent tax bracket at \$12,400 of income. If HB 115 were to pass, the state would collect its tax on income distributed to an Alaska resident. Therefore, trustees will only retain income in trusts if there is a compelling reason to do so. Such examples are a beneficiary who should not receive distributions because he or she has substance abuse problems, and a special needs trusts where not all the income is consumed and needs to be retained.

MR. BLATTMACHR advised that HB 115 prevents DING trusts. This is a planning strategy that is used by high income individuals who live in states that have very high state income taxes. The purpose is to avoid taxes on accumulated income. He reiterated the warning that if HB 115 were to pass, residents would use another state to create a non-grantor trust.

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MR. BLATTMACHR said regardless of the decision on what to do about taxation on resident non-grantor trusts, the trust industry feels some amendments should be made if Alaska is to remain competitive. He listed the following: [HB 115 adds a new chapter 22 to AS 43.]

- Trusts should receive the \$10,300 exemption that individuals receive.
- If Alaska foregoes an income tax regime, Sec. 43.22.020(c) should make an affirmative statement that nonresident trust and estates are not subject to Alaska income tax.
- Sec. 43.22.040(a) references 26 U.S. Code § 651 and it should also reference 26 U.S. Code § 661.
- Sec. 43.22.150(1) provides a definition of domicile. It says an individual might be considered a resident if their dental and medical services are provided in the state. He opined that this might discourage former residents from returning to Alaska to get these services from their established dentist or doctor. He acknowledged this isn't trust related.
- Sec. 43.22.150(19) defines a resident trust. This should include a definition as to when a transfer to a trust is deemed to have been made.
- Sec. 43.22.150(19) should make an affirmative statement that if a nonresident transfers property to an Alaska trust, it is deemed a nonresident trust.

MR. BLATTMACHR highlighted that the definition of a resident trust in HB 115 may discourage Alaskans from planning in Alaska. For example, if a resident created a trust for children residing in Montana and Texas, the accumulated income from the trust would be subject to Alaska income tax.

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CHAIR COSTELLO asked how many trusts are registered in Alaska.

MR. BLATTMACHR said his institution has created about 2,600 different trusts, and that is just a small representation of the

number of trusts that have been created in Alaska. Not every individual needs the services of a professional trustee and practitioners estimate that they create as many as one in four trusts or as few as one in eight.

CHAIR COSTELLO asked how HB 115, as written, would affect his business.

MR. BLATTMACHR said the bill is okay as written, but it's not great. The problem relates to the public perception. Alaska started the "new age" trust industry 20 years ago and it's regarded as the gold standard. If HB 115 were to pass as currently written, Alaska would no longer hold that distinction. He opined that significant business would be lost due to the public perception. It doesn't help the industry move forward.

CHAIR COSTELLO found no further questions, thanked Mr. Blattmachr, and held HB 115 in committee.

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There being no further business to come before the committee, Chair Costello adjourned the Senate Labor and Commerce Standing Committee meeting at 2:55 p.m.