Bill History/Action Display

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BILL: HB 320
BILL VERSION:
CURRENT STATUS: (H) W&M
THEN EDT, L&C, FIN
SPONSOR(s): REPRESENTATIVE(s) SEATON

SHORT TITLE: APPORTIONMENT OF BUSINESS INCOME

STATUS DATE: 05/14/03

TITLE: "An Act relating to apportionment of business income; and providing for an effective date."

Bill Root: Display Bill Root Next Bill

Full Text

Committee Action with Bill History

Jrn-Date	Jrn-Page	Action
05/14/03	1631	(H) READ THE FIRST TIME - REFERRALS
05/14/03	1631	(H) W&M, EDT, L&C, FIN
05/14/03	1631	(H) REFERRED TO WAYS & MEANS

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HOUSE BILL NO. 320

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-THIRD LEGISLATURE - FIRST SESSION

BY REPRESENTATIVE SEATON

Introduced: 5/14/03
Referred: House Special Committee on Ways and Means, House Special Committee on Economic Development, International Trade, and Tourism, Labor and Commerce, Finance

A BILL

FOR AN ACT ENTITLED

"An Act relating to apportionment of business income; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

*** Section 1.** AS 43.20.021(a) is amended to read:

(a) Sections 26 U.S.C. 1 - 1399 and 6001 - 7872 (Internal Revenue Code), as amended, are adopted by reference as a part of this chapter. These portions of the Internal Revenue Code have full force and effect under this chapter unless excepted to or modified by other provisions of this chapter. [HOWEVER, NOTHING IN THIS CHAPTER OR IN AS 43.19 (MULTISTATE TAX COMPACT) MAY BE CONSTRUED AS AN EXCEPTION TO OR MODIFICATION OF 26 U.S.C. 883.]

*** Sec. 2.** This Act takes effect immediately under AS 01.10.070(c).

ALASKA BUSINESS TAXATION:

S CORPORATION

PROJECT REPORT

July - August 1997

Olga Y. Paluba
Graduate Intern
Income and Excise Audit Division
Alaska Department of Revenue

Acknowledgment Letter

This S Corporation project report would not have been possible to complete without assistance of many Income and Excise Audit Division (IEAD) employees. Although not a big report, in doing it I have accumulated large debts. One set of these is to Brett Fried who introduced me to IEAD, was always there to help with the project, supplied me with ideas to explore, motivated me, and edited the multiple drafts.

A second set of debts is to Bob Bartholomew and Larry Meyers who initiated this project and did much to sharpen the focus of the report during our weekly meetings.

Third, I would like to thank Paul Dick, Bob LaTour, and Cliff Doherty for taking time to answer my questions, contribute to the project, and edit the drafts; Carl Meyer for legal advice; Brenda Vaughn for administrative support and her kindness; John Johnson and Rex Richardson for opening to me several important secrets of my computer. I appreciate the efforts and assistance of many others for making it easier for me to adjust to the new environment and gain practical knowledge about taxation and state revenue issues.

Every intern should be so lucky as to have such generous and self-sacrificing backup support and an opportunity to be part of a very disciplined, dynamic, and devoted team.

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Executive Summary

In 1997, the Alaska Department of Revenue conducted a research project exploring the structure of business taxation. The focus of the discussion was S corporation election and its effect on state revenue. The purpose of this project was to provide policy and decision makers with facts pertinent to the status and treatment of S corporations in Alaska. The major findings of this research are outlined below:

- Out of approximately 70,000 businesses in Alaska only 10% are subject to Alaska income tax.
- Since FY 92, the growth of Alaska tax returns filed by S corporations has been 38%, while returns by C corporations has grown by only 2%.
- $17 million is the estimated amount of revenue loss in FY 97 due to the nontaxable status of S corporations in Alaska.
- Among the states there are no uniform rules governing the taxation of an S corporation and its shareholders. Some states tax S corporations in the same manner as they tax other corporations.
- Alaska recognizes S corporations but imposes no corporate or personal income tax.
- S corporation election in Alaska is not industry-specific, but is spread throughout all major industries.
- Half of foreign S corporations that have nexus with Alaska are based in Washington; 40% of these are fishing businesses.

Introduction

Alaska has for a long time tried to come to terms with its dependence on oil revenues. Recommendations made by the Long Range Financial Planning Commission in 1995 include increasing excise taxes and user fees. One strategy that has not been widely explored is revisiting the structure of the Alaska business income tax.

Alaska has approximately 70,525 businesses (see table 1 and chart 1) of which 12,045 are corporations. Surprisingly, only 23% of these corporations pay any tax. Of these taxpaying businesses, 82% of the total corporate tax is paid by the top 10 corporations, six of which are oil and gas companies (see Appendix A).

One of the reasons for the small percentage of companies that pay business tax is the popularity of business structures that are not taxed on their net income, such as S corporations.

The FY 97 projected revenue loss from S corporation election was $17 million.

This report addresses the following topics:

- different types of business structures in Alaska,
- how S corporations fit into this general framework,
- composition and tax treatment of S corporations, and
- revenue effects of S corporation election in Alaska.

Besides sole proprietorships, partnerships, limited partnerships, and corporations, businesses can now choose the following

TABLE 1: ALASKA BUSINESS STRUCTURES (FY 97)

Sole proprietorships[1]	44,589
General partnerships[1]	12,821
C corporations[2]	
Domestic[3]	4,342
Foreign	2,854
Total C corporations	7,196
S corporations[2]:	
Domestic	4,011
Foreign	838
Total S corporations	4,849
Limited partnerships (LPs)[4] :	
Domestic	211
Foreign	74
Total limited partnerships	285
Limited liability companies (LLCs)[4]:	
Domestic	642
Foreign	129
Total limited liability companies	771
Limited liability partnerships (LLPs)[4]:	
Domestic	2
Foreign	12
Total limited liability partnerships	14
Total Businesses	**70,525**

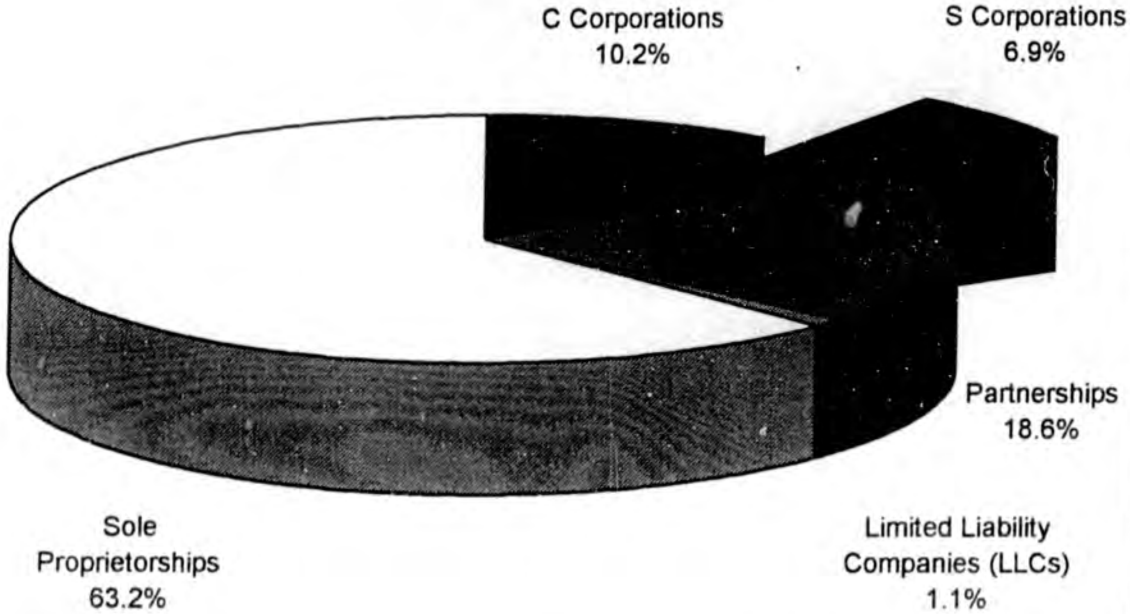
[1] Source: Alaska Department of Commerce and Economic Development (DCED). The data is based on the number of current active Alaska business licenses as of July 8, 1997.

[2] Source: Alaska Department of Revenue. The numbers represent the filing activity of businesses during FY 97.

[3] Source: Alaska Department of Revenue. The numbers represent the filing activity of businesses during FY 97.

[4] Source: DCED. The information reflects the number of businesses (as of July 1997) that have registered with DCED either since the time the entity type was created, as is the case with LLPs and LLCs, or since the time they started filing with DCED, as is the case with LPs.

CHART 1: FY 97 DISTRIBUTION OF BUSINESS STRUCTURES IN ALASKA[5]



business types: limited liability partnerships, limited liability companies, and S corporations. The most popular forms of business in Alaska are sole proprietorships (63.2%) and partnerships (18.6%).

Alaska Businesses

In the last decade several business structures types emerged and have become popular with businesses in Alaska and nationwide.

Approximately 90% of all Alaska businesses pay little (if any) tax on their net income.

The C corporation is the only business structure where profits are subject to corporate income taxes. C corporations make up approximately 10% of all 70,525 Alaska businesses.

Although all of the differences between business structures will not be addressed, a general discussion is included of how each of them regards limited liability, participation in management, and tax treatment by the Internal Revenue Service (IRS) and by the State of Alaska.

[5] Sources: DCED and Alaska Department of Revenue. Partnerships include general partnerships, limited partnerships, and limited liability partnerships. The numbers of limited (285) and limited liability (14) partnerships are so small that they were combined into a single category.

S Corporation

An S corporation is a corporation that elects S status under Subchapter S of the Internal Revenue Code[6]. By making this election the corporation chooses to be taxed as a pass-through entity, similar to a partnership or a sole proprietor.

The potential tax benefit of electing S corporation status is that income is not subject to a corporate level tax and instead "passes through" to the individual shareholders. The amount that passes through to each shareholder is in direct proportion to the size of their ownership interest in the entity.

C Corporation

Generally, corporations that do not or cannot elect S corporation status are considered C corporations. The federal government and the State of Alaska levy a tax on the earnings at the corporate level[7]. Additionally, when income is distributed to a shareholder, it is subject to tax as part of the shareholder's individual income. In Alaska, this is only true at the federal level because the state does not have a personal income tax.

Corporations compute their tax liability based on their federal taxable income with Alaska adjustments. Alaska uses an apportionment method to determine the share of income that is taxable in the state. Corporations, other than oil and gas corporations, apportion their income to Alaska by using a three-factor formula based on sales, property, and payroll. Oil and gas corporations use a modified apportionment formula.

[6] IRC 1361-79
[7] AS 43.20

The applied tax rate is measured in $10,000 increments and ranges from 1% to 9.4%. Corporate income over $90,000 is taxed at the 9.4% rate.

Other Pass-through Entities

Pass-through entities are not subject to the Alaska corporate income tax. These entities include the following: general partnerships, limited partnerships, limited liability partnerships, and limited liability companies. A brief discussion of these entity types is found below. (See Appendix B for a more detailed comparison of all business structures.)

General partnership

This is the traditional form of partnership. General partners are liable for all debts and obligations of the business including liability for malpractice or other torts of partners and employees. In terms of liability, general partnership (GP) offers no protection.

Limited partnership

Limited partnership (LP) is a form of partnership that consists of at least one general partner who accepts unlimited liability and other members, known as limited partners. The latter are personally liable only for their capital contributions and future contributions to which they are committed.

Limited liability partnership

Limited liability partnership (LLP) is new to Alaska. The amendment to the Uniform Partnership Act[8] became effective on January 1, 1997.

It creates a form of partnership which uses a different approach to:

- liability and
- participation in management.

[8] AS 32.05.405.—32.05.760

The legislation offers protection from the wrongful acts of other partners or third-parties and provides equal opportunities for all partners to participate in management.

The limits on vicarious liability have resulted in LLPs being mostly used by private lawyers and accountants. Under the newly-established LLP statute a partner is not, directly or indirectly, liable for the debts, obligations, and liabilities that arise from misconduct, negligence, malpractice or any wrongful acts committed by a partner or an employee. However, the personal liability for the partner's own actions remains the same. A partner is not relieved of liability for the partner's own negligence, wrongful acts, wrongful omissions, malpractice or misconduct.

Unlike in a limited partnership, where a general partner manages the enterprise himself and limited partners do not participate directly in management, in an LLP every partner takes part in all business operations and still retains limited liability for the wrongful acts, malpractice, and torts of other individuals.

Limited liability company

Limited liability companies (LLCs) are fast proving to be a popular form of doing business. Most states (48 states and the District of Columbia) have legalized the status of LLCs and allow the formation of such business structures.

The LLC is seen as a hybrid between a corporation and a partnership. It enjoys the advantage of giving members full protection from the liabilities of the entity, while at the same time being taxed as a partnership for federal income tax purposes.

This type of business structure ensures that all members are free from personal liability for the debts of the enterprise. There is no set limit on participation in management and members of an LLC can deduct business losses on their personal tax returns. In Alaska the LLC was approved in 1995[9]. The statute was amended in January 1997 to allow sole proprietors to form an LLC which before had to consist of at least two members. The expected effect of this amendment is an increase in the number of LLCs.

Additionally, the new "check-the-box" regulations[10] give an LLC owner(s) the right to decide if the business should be taxed as a partnership or a corporation. Since partnerships do not pay corporate taxes, most LLCs choose to be taxed as partnerships. In this case, their tax treatment is similar to S corporations.

New Treasury regulations eliminate the need for unincorporated businesses to guard against corporate characteristics (free transferability of interest, limited liability, continuity of life, and centralization of management) which previously could limit the ability of the business to be classified as a partnership for federal income tax purposes.

Despite the growth in the number of LLCs, many questions and issues relating to their taxation and the taxation of their members have yet to be resolved. This is a possible reason why many businesses are still cautious about choosing this type of business structure.

Business Fees in Alaska

Currently, the Alaska Department of Commerce and Economic Development collects three types of mandatory fees: organizational filing fees, biennial fees, and business license fee. The latter is submitted

[9] AS 10.50 et.seq.
[10] Treas. reg. section 301.7701

with a report if the type of entity that the business is registered under has a requirement to deliver a biennial report. In the event that a business has not paid the required fee, the State of Alaska can revoke its charter and dissolve the organization.

The rates vary and are based on the type of business structure and foreign or domestic classification. The fees listed below became effective on July 1, 1995.

Organizational Filing Fees

Domestic Corporation/ Limited Liability Partnership/ Limited Liability Company	$250
Foreign Corporation/ Limited Liability Partnership/ Limited Liability Company	$350
Domestic/Foreign Limited Partnership	$150

Biennial Fees

Domestic Corporation/ Limited Liability Partnership/ Limited Liability Company	$100
Foreign Corporation/ Limited Liability Partnership/ Limited Liability Company	$200
Domestic/Foreign Limited Partnership	$0

Most enterprises that engage in business activity in Alaska also have to obtain a business license. The cost of the standard business license is $50. There is also an additional fee of $25 for a tobacco sales endorsement.

The Alaska Department of Revenue does not charge any fees for processing taxpayers' returns.

TABLE 2: TAX FILING OPTIONS FOR ALASKA BUSINESSES

How Registered or Licensed with Alaska	How Classified Federally and with Alaska for Tax Purposes	Alaska Form Filing Requirements
C Corporation Limited Liability Company (LLC)	C Corporation	1120, AK 04-611 or AK 04-650
S Corporation	S Corporation	1120S, AK 04-611
Limited Partnership (LP) Limited Liability Partnership (LLP) Limited Liability Company (LLC) General Partnership (GP)	Partnership	1065 (If a partnership has a corporate partner (s), a separate return is required for that partner.)
Sole Proprietor Limited Liability Company (LLC)	Sole Proprietor	No Filing Required
Non-Profit	Exempt	990 and/or 990T, If 990T, Then AK 04-611

Tax Filing Options

The IRS and Alaska distinguish between an S corporation, C corporation, partnership, sole proprietor, and exempt.

Table 2 outlines the filing options for businesses in Alaska and the respective filing requirements. Entities like LPs, LLPs, and LLCs must fall into one of the existing tax categories and do not constitute a separate tax group.

Growth in Use of S Election

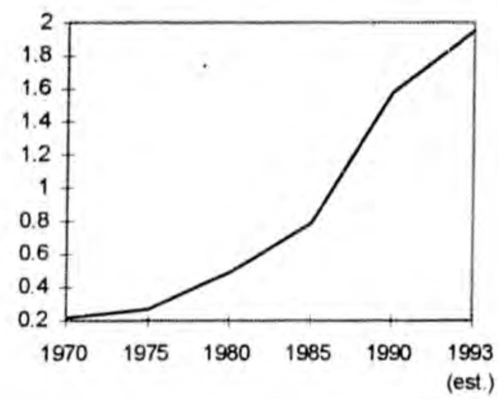
Historic Trends: S Corporations

Speakers at the 1991 annual conference of the National Tax Association—Tax Institute of America—reported that the dollar volume of assets held by S corporations doubled between 1986 and 1988, with states suffering huge revenue losses because of the wave of conversions to S status[11].

During the years 1970-1993 the Internal Revenue Service observed a rapid growth in the number of tax returns filed by S corporations.

As shown on the graph (see chart 2), their numbers have increased almost ten times since 1973, from approximately 200,000 to 2 million. In Alaska, the increase in the number of returns filed during the last several years can be attributed to the increase in the number of returns filed by S corporations, from 3,033

CHART 2: S CORPORATIONS, THE RISING TIDE[12]



S corporation returns filed (millions)

Table 3: RETURNS FILED WITH THE STATE OF ALASKA[13]

FY	S Corporation	C Corporation
92	3,033	7,071
93	3,388	6,873
94	4,106	7,163
95	4,541	6,774
96	4,619	7,318
97	4,849	7,196

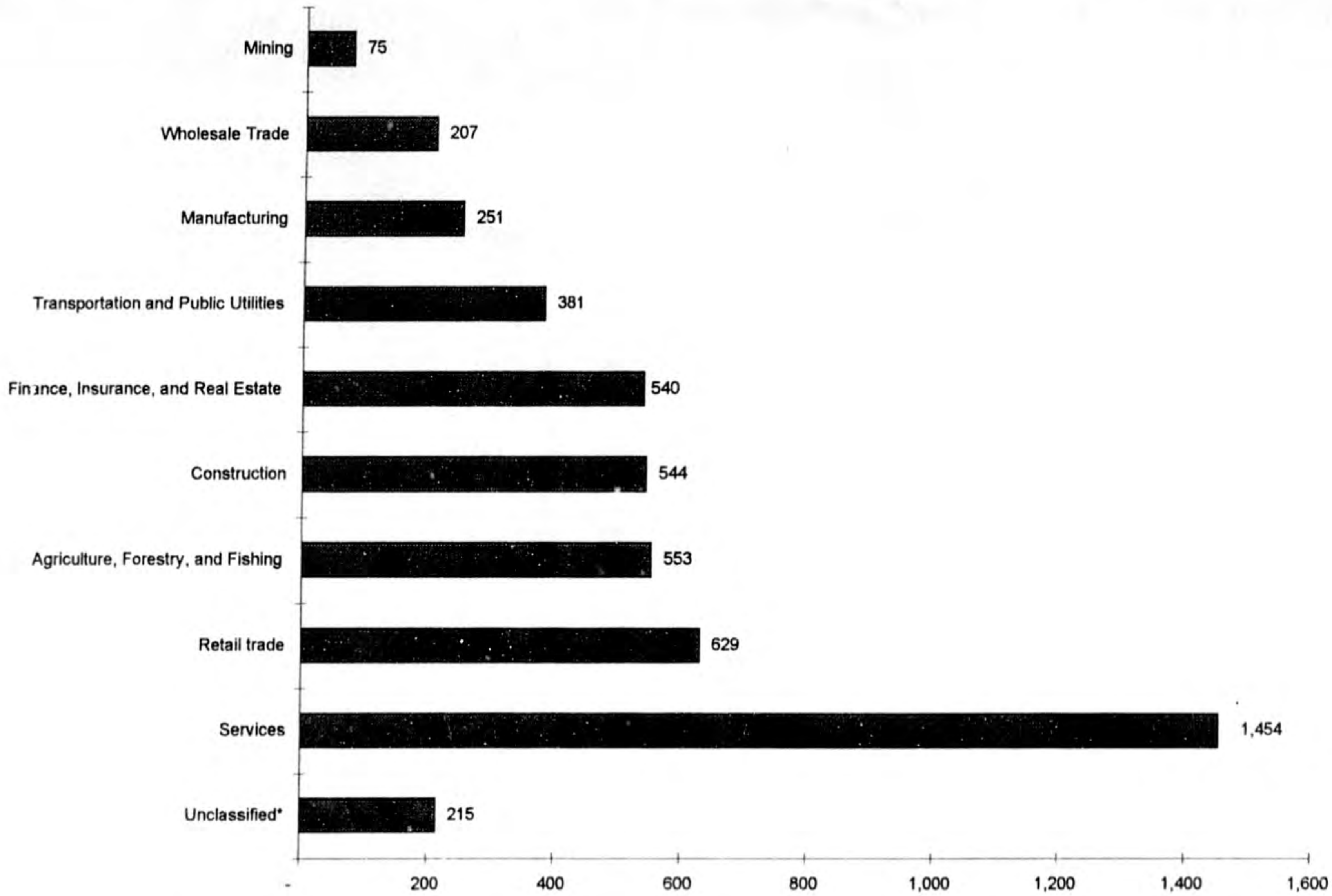
in FY 92 to 4,849 in FY 97, an increase of 38% (see table 3). However, because changes in filing activity also reflects changes in compliance efforts and how returns are filed, this does not necessarily imply an equally high growth rate in S corporations.

[11] State Tax Notes, Tax Analysts, Nov. 13, 1991, 91 TNT 232-9.

[12] Source: Journal of Accountancy, February 1994, p.29

[13] Source: Alaska Department of Revenue, Income and Excise Audit Division

CHART 3: Principal Business Activity of S Corporations in Alaska in FY 97



* This category includes all companies that fall under "unclassified establishments" group of the business activity code as well as corporate taxpayers whose information on business activity is missing on their tax returns.

With the increased flexibility accorded to S corporations by the IRS, further popularity of this business structure type seems to be very likely.

Industry and Geographic Composition of S Corporations in Alaska

S corporations in Alaska are present in most major industries (e.g. fishing, construction, finance, real estate, services, manufacturing) and are most prevalent in the service sector. 30% of the total S corporation returns received by the Department of Revenue in FY 97 are from companies whose main business activity is the provision of services (see chart 3).

The service provider category includes a wide variety of businesses: from hotel and other lodging places to amusement and recreation services, from medical facilities to law firms, and from auto repair to accounting services.

Approximately 80% of Alaska S corporations are domestic. The other 20% are foreign companies who have nexus with Alaska and are headquartered in 47 different states. 50% of them are based in Washington state.

CHART 4: WASHINGTON-BASED S CORPORATIONS' ACTIVITY IN ALASKA (FY 97)

Not surprisingly, over 40% (or over 160 businesses) of Washington-based S corporations in Alaska are part of the fishing industry or agriculture.

Federal Regulations and Their Significance for Alaska Firms

Alaska generally follows the federal pattern pertaining to S corporations including eligibility requirements and tax policy on certain entity level taxes that apply to C corporations transferring to S status. For example, if an S corporation has passive investment income or built-in-gains subject to taxation under the Internal Revenue Code, Alaska taxes the same amount.

Subchapter S of the Internal Revenue Code

The history of S corporations started in 1958 when the federal government created Subchapter S of the Internal Revenue Code to stimulate the economy, promote small businesses, and provide an incentive for selecting the corporate form of business.

S corporations were created in 1958, but it was not until the 1980s that they became a popular way of structuring business.

Major changes pertaining to S corporation status and eligibility requirements were introduced in the 1980s and 1990s in the amendments to the S corporation rules. The 1982 act divided all corporations into two groups: (1) S corporations that make an election to be taxed under Subchapter S and (2) C corporations, which are all other corporations[14].

Revenue Reconciliation Act of 1993

This legislation increased the maximum individual income tax rate to 39.6% (for taxable income over $250,000) and the maximum corporate income tax rate to 35%

[14] 26 U.S.C. 6242 et.seq.

(for taxable income over $10 million). As a result, the maximum tax rate of S corporations became 39.6%, whereas C corporations had a lower maximum tax rate of 35%. Many S corporations revoked their S election after the passage of this act.

Small Business Job Protection Act of 1996

This act was more favorable to S corporation owners and shareholders than the previous amendments to S corporation rules and regulations. The following significant changes in the eligibility requirements were made by this act:

- The maximum number of S corporation shareholders was expanded to 75.
- Electing small business trusts were added to the list of trusts that are eligible to be S corporation shareholders.
- An S corporation was allowed to have C corporation and/or S corporation subsidiaries.
- Debt owed by an S corporation was not to be treated as a second class of stock; the eligible creditor requirement was expanded to include banks and other entities engaged in the business of lending money.

These changes allow businesses organized as S corporations much greater flexibility in conducting their operations than was available in prior years.

S Corporation Features

General observations

Deductibility of losses

Aside from avoiding tax at the corporate level, one of the primary advantages of using an S corporation election is the right of its members to use business losses to offset individual income. These losses pass through to the member's personal income tax return (IRC 1366 and 1374).

S corporation shareholders can write off their share of operating losses against their income only to the extent of their tax basis; that is, their investment in shares or loans to the corporation. Losses in excess of shareholders tax basis are carried forward to future tax years and applied against any profits earned by the corporation or against additional investments made by shareholders.

Deductibility of interest

Interest that is incurred when buying S corporation stock is potentially deductible as an investment interest expense.

Payroll taxes

Shareholders are subject to payroll withholding requirements. Any residual income is divided among shareholders and is subject to federal and state income tax, but not self-employment tax.

Restrictions on formation, operation, and disposition of the business

There are several restrictions imposed on S corporations (number of shareholders, class of stock, etc.). A corporation that does not satisfy any one of the requirements, cannot qualify for S election.

Existing S corporations that do not comply with the IRS or state rules are subject to S corporation election revocation. Limitations associated with S corporations status are stated in Subchapter S of the Internal Revenue Code and subsequent changes in S corporation rules.

Alaska-specific issues

The intent of Subchapter S creation was to free corporations from corporate income tax and to preclude double taxation. S corporations receive the same treatment on the federal level but their treatment on the state level widely differs.

Alaska recognizes S corporations but imposes no personal income tax; so no income tax is collected on any level, be it corporate or shareholder.

Status and Tax Treatment of S Corporations in Other States[15]

Although S corporations are not taxable for federal corporate income tax purposes, their state treatment differs from state to state. Among the states, there are no uniform rules governing the taxation of an S corporation and its shareholders.

Following the federal pattern

Most states have adopted the federal approach to taxation of S corporations and recognize a valid federal S election. As a result, the net income of the corporation is taxable directly to the shareholders for federal and state income purposes. However, the recognition of S status by a state does not always imply that the corporation will be exempt from a business license, franchise, or income tax.

California, New Jersey, and New York recognize the S election, but for corporate income tax purposes its only effect is to subject the S corporation to a tax rate less than the C corporation rate. For example, California imposes a 1.5% surcharge on S corporation income. The normal franchise tax rate is 9.3%.

In Massachusetts, S corporations with total receipts exceeding $6 million are subject to the corporate income tax.

In many cases, states levy minimum income taxes that apply to all taxpayers, including S corporations. In the District of Columbia, S corporations are subject to a $100 minimum tax. Minnesota subjects S corporations—whose payroll, property, and sales are not more than half a million dollars—to a minimum fee based on taxable income apportioned to Minnesota. This fee can be as much as $5,000.

New York enacted a special corporate level tax on S corporation income at a rate equal to the difference between the maximum rate applicable to the individual income and the maximum rate applicable to corporation income. New York added a temporary 15% surcharge on corporate income tax liability which applies to S corporations with net incomes of more than $200,000[16].

Election not recognized

Some states—Connecticut, the District of Columbia, New Hampshire, Tennessee—do not recognize the S election with respect to the corporate income tax; therefore S corporations are taxed in those states like C corporations.

Texas, while recognizing a distinction between S and C corporations, imposes its franchise tax on both and does not tax

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15 Source: Raabe, William A. and Karen J. Boucher. 1997 Multistate Corporate Guide, vol. 1, pp. 135-138. New York, NY: Panel Publishers, 1997.

16 Source: Willson, Prentiss and Mark Windfeld. Tax management multistate tax portfolios. State taxation of pass-through entities: general principles. Washington D. C.: Tax Management, Inc., 1994.

individual income, so the effect is similar to disregarding S status.

No corporate taxation

Nevada, South Dakota, Washington, and Wyoming form a special group. They do not have corporate taxes. However, several of them use other avenues for collecting taxes on the entity level.

For example, Washington state imposes a tax on gross income of corporations (C, S, and nonprofit), partnerships, and sole proprietors from their activities in the state. Called business and occupation (B&O) tax, it is the second leading tax source for Washington state. In FY 95, B&O tax collections totaled 1.59 billion dollars, which represented approximately 17% of all taxes levied by the state[17].

State Revenue Effects of Subchapter S Corporation Election

In FY 97, Alaska lost an estimated $17 million due to current nontaxable status of S corporations.

Approximately $12 million of the total $17 million loss is from Alaska-based businesses and $2.5 million from foreign S corporations (see Appendix C).

When a company conducts business in more than one state, there is a question as to what share of its total income is taxed in a particular state. The amount of taxable income in Alaska is calculated by using an apportionment formula to identify the corporation's total Alaska taxable income. The apportionment method employs a three-factor formula. These factors are payroll, property, and sales. Although there is no uniform apportionment formula in the US, most states, including Alaska, adopt the Uniform Division of Income for Tax Purposes Act (UDITPA) that uses a three-factor formula. In Alaska all three factors, payroll, property, and sales, are weighted equally[18]. (For a more detailed description of apportionment calculation, see Appendix D.)

In our computations, the major assumption is that S corporations will not change their expenditure pattern and/or their income in response to a change from nontaxable to taxable status.

Alaska S corporations are assigned an apportionment factor of 1 which means that all their business net income is taxable in the state. However, there may be some firms designated as Alaskan that have apportionment factors less than one. To estimate the apportionment factor of foreign S corporations, the FY 97 apportionment factors of foreign non-oil and gas C corporations are averaged.

Washington-based C corporations have a much higher average apportionment factor than C corporations from other states. This generally shows a high level of business activity and a large portion of net income being derived from Alaska. Additionally, considering that Washington-based S corporations represent almost half of all foreign S corporations in Alaska, gives us another reason to examine them separately. Their apportionment factor is 9 times greater

17 Source: Information on Washington's Tax Structure. Business and Occupation Tax. Washington Department of Revenue.

18 AS 43.19.010, 43.20.065

than the apportionment factor of S corporations based in other states. When projecting revenue loss from S election in Alaska we use three apportionment factors. They are applied to:

1. Alaska-based S corporations (1.00)
2. Washington-based S corporations (.27)
3. Other foreign S corporations (.03)

This three-tiered approach reflects the best distribution of business involvement in Alaska. Intentionally while averaging apportionment factors, foreign C corporations with 100% taxable income in Alaska are excluded from the sample. This exclusion eliminates overestimating revenue loss.

* * *

In this report we explored the current composition of businesses in Alaska and the structure of the state business income tax. Although we briefly examined all business structures, the focus of this report was S corporations. We provided historical background information on S corporation election, current information on the make-up of S corporations in Alaska, and estimate of projected revenue loss from S election.

With the popularity of new business structures, there will certainly be need for examining them. We hope we have provided a framework for future work in this area.

Appendices

APPENDIX A

FY 97 CORPORATION TAX LIABILITIES STATISTICS

	Oil and Gas Corporations			Other than Oil and Gas Corporations			All Corporations		
Alaska Net Income	**# Filers**	**Amount**	**% Total**	**# Filers**	**Amount**	**% Total**	**# Filers**	**Amount**	**% Total**
Above $1 million	6	$161,162,466	97.20%	4	$7,236,689	17.68%	10	$168,399,155	81.46%
$500,000 - $1 million	4	3,129,368	1.89%	15	10,737,397	26.23%	19	13,866,765	6.71%
$100,000 - $499,999	5	1,404,626	0.85%	53	11,949,087	29.19%	58	13,353,713	6.46%
$50,000 - $99,999	1	53,153	0.03%	53	3,636,859	8.89%	54	3,690,012	1.78%
$10,000 - $49,999	1	43,521	0.03%	206	4,720,318	11.53%	207	4,763,839	2.30%
$ 1,000 - $9,999	3	10,391	0.01%	658	2,277,593	5.56%	661	2,287,984	1.11%
$100 - $999	3	1,167	0.00%	816	331,666	0.81%	819	332,833	0.16%
$1 - $99	2	14	0.00%	1,301	39,954	0.10%	1,303	39,968	0.02%
Zero Tax	11	0	0.00%	10,431	0	0.00%	10,442	0	0.00%
Total	36	$165,804,706	100.00%	13,537	$40,929,563	100.00%	13,573	$206,734,269	100.00%

Note: Amounts reflect tax liabilities reported on the taxpayer original returns. Liabilities may differ from amounts remitted by the taxpayer during the fiscal year due to timing differences resulting from estimated tax payments, credits, and final payment of taxes reported. Corporations include here Subchapter S, Subchapter C, Homeowner's Association, Exempt, Oil and Gas.

APPENDIX B

COMPARISON OF ENTITY STRUCTURES

Page 2 of 2

Entity Type	Offers Continuity of Life?	Managing Body	Levels of Income Tax	Deductibility of Losses Attributable to Entity Debt	Entity Taxed in Alaska?
General Partnership	No	Partners	Individual capacity	Partners may deduct partnership losses only to extent of basis[3].	No[4]
Limited Partnership	No, but the entity can be reconstituted by general partner or by agreement of all remaining partners.	General partner—limited partners may not participate in management.	Individual capacity	General partners only may deduct partnership losses to extent of basis[3], unless limited partnership assumes liability.	No[4]
Limited Liability Partnership	No, unless partnership agreement provides otherwise.	Partners	Individual capacity	Same as with general partnership	No[4]
Limited Liability Company	No, unless regulations provide otherwise or members unanimously consent to continue business.	Managers, unless regulations reserve the right to members.	Individual capacity	Members may deduct the LLC's losses only to the extent of their basis[3] which includes their allocable share of LLC debt.	No[4], if elects to be taxed as partnership.
S Corporation	Yes, unless it is terminated by the IRS due to a prohibited activity.	Board of Directors	Only shareholder level.	Shareholders may deduct the corporation's losses only to the extent of their tax basis[3] of their stock which does not include any portion of the corporation's debt.	No
C Corporation	Yes	Board of Directors	Corporate and shareholder level	Shareholders may not deduct any of corporation's losses.	Yes

[3] A partner's basis (or member's in case of LLC) in his or her share of business includes money invested plus the adjusted basis of property contributed to an enterprise.

[4] A C corporation that is a partner or a member of a business is required to report its income or loss.

APPENDIX D
APPORTIONMENT CALCULATION

The following is an example of how the tax liability of a C corporation in Alaska is calculated. This process can be broken down into three steps:

1. Calculate the apportionment factor
2. Compute the taxable income
3. Determine the applicable tax rate

Example:

	Alaska	Total US
Sales	$300,000	$500,000
Property	100,000	750,000
Payroll	150,000	300,000
Total	$550,000	$1,550,000

1. Apportionment factor

Computations:

Sales	$300,000 / $500,000 =	60.00%
Property	$100,000 / $750,000 =	13.33%
Payroll	$150,000 / $300,000 =	50.00%
Apportionment formula average (total / 3)		**41.11%**
Apportionment factor		**.41**

2. Taxable income in the state

Income apportioned to Alaska is computed by applying the apportionment factor to total business net income.

Assume that the business net income of our company is $1,000,000 and apply the apportionment factor to that income. Then taxable income in our example equals $410,000; that is .41 x 1,000,000.

3. Tax rate and tax liability

On taxable income of more than $90,000 in Alaska, the tax is $4,500 plus 9.4% of the taxable income over $90,000 which equals $34,580. This is the amount that our hypothetical corporation has to pay in taxes to the State of Alaska.

The same three-step process is used in estimating the FY 97 revenue loss due to S corporation election in Alaska.