Testimony before the Alaska House Labor & Commerce Committee On House Bill 36

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Thank you for the opportunity to testify on the changes House Bill 36 would make to Alaska's tax treatment of pass-through income. The taxation of pass-through business entities has been a focal point of state and federal tax reform debates for over a quarter century, with a dual focus on minimizing the role of tax laws in determining the choice of business entity and on ensuring that the income of all business entities is subject to at least a minimal tax. My testimony makes two main points:

1. Alaska is one of a small number of states that do not currently impose either an entity-level tax or a personal income tax on the income generated by pass-through businesses. But Alaska fully taxes the income of traditional C corporations, creating a clear incentive for businesses to structure as pass-throughs to avoid income tax.
2. In the absence of a statewide personal income tax, imposing an entity-level tax on the net income of pass-through businesses, as HB36 would do, is a straightforward approach to leveling the playing field between different types of business entities, while ensuring these businesses help to fund public investments.

Current Approaches to Taxing Pass-Through Income

Under federal income tax rules, the income of corporations is generally subject to the corporate income tax. Exceptions are made for sole proprietorships, partnerships, S corporations and limited liability companies. These companies are known as "pass-through" entities because their income is taxed directly to the individual owners of the companies, and the companies themselves are not subject to an entity-level federal income tax.

Forty-one states and the District of Columbia levy broad-based personal income taxes, and almost all of these jurisdictions mirror the federal income tax treatment of pass-through entities. That is, owners of pass-through entities in these states typically include their income from these entities in their gross income subject to personal income taxes, and apply the same marginal tax rates to pass-through income that are applicable to salaries, wages, and other forms of personal income.

Four personal-income-tax states have enacted special tax rules that treat pass-through income differently from other forms of personal income. Most notably (and most controversially), Kansas completely excludes pass-through income from its personal income tax (although the wages paid by pass-through businesses are still subject to the state's personal income tax.) Ohio excludes the first $250,000 of pass-through income from the personal income tax, while fully taxing wages associated with pass-through businesses. Oregon applies the same top tax rate to pass-through and other forms of income, but uses much wider tax brackets for active pass-through income, with the 9.9 percent top rate only applying over $5,000,000. South Carolina applies a flat tax rate of 3 percent to certain income of pass-

through businesses, while taxing other income (including wages associated with pass-throughs) at a top rate of 7 percent.

Nine states do not levy a broad-based tax on personal income, creating at least the potential for a substantial inequity between the tax treatment of the income of C corporations and the treatment of pass-through businesses. These states are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming. The nine non-income tax states have taken a variety of approaches to taxing pass-through entities' income:

- Include some pass-through income in corporate income tax base (New Hampshire, Tennessee)
- Impose gross receipts tax on revenues of pass-through (and other) business entities (Nevada, Texas, Washington)
- Exempt all income of pass-through entities (Alaska, Florida, South Dakota, Wyoming)

Alaska is one of four states that generally exempt all income of pass-through entities from tax. But two of these states (South Dakota and Wyoming) don't impose any entity level income tax on traditional C corporations. Only Alaska and Florida fully tax C corporations while fully exempting the income of pass-through businesses.

It is impossible to measure the extent to which the potential state tax reductions associated with pass-through status have encouraged business owners to incorporate as pass-throughs rather than C corporations. State taxes are only one factor driving this decision; other factors, including the regulatory and legal structure governing each form of entity as well as the much higher federal tax rates facing business income both on the personal and corporate tax side, likely play as important a role. Yet it has been widely acknowledged for decades that, absent other constraints, business owners can zero out their Alaska income tax liability simply by organizing as a pass-through rather than a C corporation. As early as 1998, Alaska Deputy Revenue Commissioner Deborah Vogt observed that '[i]n a place that doesn't have a state income tax you'd be an idiot to start up a C corporation."

To the extent business leaders have taken Commissioner Vogt's advice in the last two decades, the most obvious effect on Alaska's economy has been a gradual drain on the yield and fairness of the state's corporate income tax. Tax fairness is an important goal, in part, because obvious violations of the tax fairness principle reduce the public's confidence in the workings of the tax system, in the state government officials who administer the tax system, and the state legislators who are charged with maintaining a modern and effective set of tax laws. And in a fiscally challenging environment, the revenue losses associated with any form of tax avoidance must be made up by higher taxes on the rest of us. But the gap between the tax treatment of pass-throughs and C corporations also threatens the long-term economic growth of the state of Alaska.

Among the basic principles of a sound tax reform is "tax neutrality," which is achieved when individuals and businesses make their investment and other fiscal decisions based on their economic merits, rather than making these decisions for tax reasons. For anyone seeking to maximize state economic growth, neutrality should be an important goal: after all, when companies make investments based on tax rules rather than basing their decisions on market forces, they are by definition making investments that are inefficient. While a neutral tax system is virtually impossible to accomplish in the real world, policymakers can take important steps toward this goal by avoiding fiscal policies that provide strong incentives for businesses to act in a certain way for reasons that have little or no economic substance other than tax savings. The substantial difference between Alaska's 9.4 percent top corporate income tax rate and the 0 percent rate available to companies that restructure as non-C corporations appears to be a clear example in which equalizing these two tax rates might achieve efficiency gains for the Alaska economy.

Impact of House Bill 36

House Bill 36 would take a step toward equalizing the Alaska income tax treatment of C corporations and pass-through entities, by imposing an entity level tax on the income of sole proprietorships, partnerships, limited liability corporations and S corporations. The bill would impose a graduated tax, with a zero tax rate on the first $250,000 of taxable income for each entity, and tax rates gradually increasing to 9.4 percent on taxable income exceeding $1

million. By comparison, traditional C corporations pay a zero percent tax rate only on the first $25,000 of taxable income, and pay the 9.4 percent marginal tax rate on taxable income exceeding $222,000. By these measures, the proposed tax brackets for pass-through businesses would likely exempt proportionally more businesses from tax than the brackets applicable to C corporations, and would likely result in lower effective tax rates across the board on pass-through businesses than those facing C corporations.

By equalizing the top marginal rate on pass-through and C corporations, HB 36 would dramatically reduce the incentive for new Alaska businesses to choose their form of entity, and for existing businesses to restructure their legal form, for no reason other than tax avoidance. The bill would also raise needed revenues to help balance the state's budget going forward. And, importantly, the bill would end a clear inequity in the tax system that allows adept tax planners to pay far less taxes than equally situated competitors that have not reorganized for tax purposes.

Thank you for the opportunity to testify.