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Preliminary Report of the Select Commission on Comprehensive Tax Reform

Maine State Legislature

Office of Fiscal and Program Review

Kevin M. Madigan

Maine State Legislature

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MAINE LEGISLATURE

PRELIMINARY REPORT

of the

SELECT COMMISSION

on

COMPREHENSIVE TAX REFORM

December 5, 1990



DEC 20 1990



MAINE STATE LEGISLATURE
Augusta, Maine 04333

December 5, 1990

The Honorable Charles P. Pray, President of the Senate
The Honorable John L. Martin, Speaker of the House
Members of the 115th Legislature

It is my pleasure to transmit the Preliminary Report of the Select Committee on Comprehensive Tax Reform.

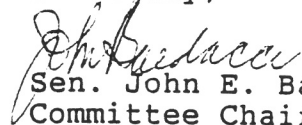
We have concluded our initial review as required by statute. We used a subcommittee process that recognized the individual and collective talents of nearly 50 people, not counting all of the interested parties that came before us with their comments, criticisms and concerns. The full Committee of 13 is now prepared to take this document, along with any additional ideas you may have, and complete its task by the end of January.

The administration has promised to work with us in two specific areas. They will be providing us with an up-to-date analysis of the income tax system because this information was not available during our preliminary review. They will also be talking with us about the impact of the budget shortfall on future budgets of the State, counties and municipalities. A significant number of future cost bills were passed last session and this issue must be addressed.

In the course of our review and most pointedly in the last few days, the magnitude of the current fiscal year crisis was identified. While the Commission expressed some early concern about this issue, we specifically refrained from looking at it closely during the subcommittee phase of our work. We may no longer be able to avoid it and if it is your wish, we are ready to use our remaining time as the basis for addressing this crisis situation.

On behalf of myself, the Committee members and the subcommittee members who so willingly served, I want to thank you for the opportunity to look at tax reform. We look forward to continuing this work and providing you with a number of useful recommendations in our final report.

Sincerely,


Sen. John E. Baldacci
Committee Chair

Enclosure

Commission Members

Sen. John Baldacci, Chair
Rep. Guy Nadeau, Vice-Chair
Sen. Stephen Estes
Rep. Walter Whitcomb
Rep. Clyde Hichborn
Rodney Scribner, State Auditor
John LaFaver, State Tax Assessor
H. Sawin Millett, Commissioner of Finance
Richard Silkman, Director,
State Planning Office
Bonnie Post, General Public
William Hamlin, General Public
Steven Deller, General Public
Barry Larman, General Public

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The Process

The Select Committee on Comprehensive Tax Reform was created by LD 2390, PL 1989, C 880, Part I. This statute required that the Committee undertake a study of the current taxation system and tax policies in the State and strive to establish a comprehensive tax reform package. As part of the study, the Committee had to review:

1. The current procedures raising revenues through taxation in the State and determine the progressive or regressive nature of the various taxes;
2. Inconsistencies in the current tax scheme, including inconsistent sales tax rates and inconsistent rates imposed on selected services with a goal of removing those inconsistencies;
3. Exemptions under the sales and use tax and income tax laws;
4. Revenue policy in other jurisdictions; and
5. Any anticipated restrictions on and demands for revenue that would have to be included in future budgets of the state, counties and municipalities.

The Committee was authorized to form subcommittees to better perform its duties. The members of each subcommittee and the specific charges imposed on each subcommittee precede each of the respective reports. These individual subcommittee reports make up the preliminary report that is due to the Legislature by December 1, 1990. The final report is due, together with any implementing legislation, by January 30, 1991.

Subcommittee 1
Sales Tax - Sales Tax Exemptions

EXECUTIVE SUMMARY

- (1) The subcommittee believes that the state should adopt a clear statement of philosophy as to which economic events should be subject to sales and use tax and which should not.
- (2) If additional revenue is realized from any changes made to bring the sales and use tax law into conformity with the principles outlined in this Report, it should not be used to raise the heavy tax burden which Maine taxpayers currently face.
- (3) As a matter of principle and general philosophy, the sales and use tax base should:
 - A. Not discriminate between economic sectors;
 - B. Provide reasonable revenue stability and growth;
 - C. Be sufficiently consistent in its applications so that taxpayers have reasonable certainty as to what is taxable and what is not taxable;
 - D. Contain provisions which promote progressivity of the sales and use tax; and
 - E. Contain provisions necessary to protect the competitiveness of the Maine economy.
- (4) Transactions should generally be exempt only if they fall within one of the following categories of exceptions:
 - A. Necessities of life exemptions which help promote progressivity in the sales tax law.
 - B. Transactions which must be exempt due to federal law or state constitutional law.
 - C. Purchases by the State, political subdivisions or the federal government.
 - D. Transactions which should be exempt for reasons of administrative convenience.
 - E. Exemptions which prevent "pyramiding".
 - F. Exemptions necessary to protect the competitiveness of the Maine economy.
 - G. Certain non-profit organizations.

- (5) The subcommittee recommends that either the exemption for food be rewritten to eliminate the various inconsistencies or that the exemption for food be repealed in its entirety.
- (5-A) The subcommittee emphasizes that all tax credit concerns must be studied in depth and measures must be identified to eliminate these potential problems before any action is taken to repeal the exemption for food and institute a new refundable credit.
- (6) The subcommittee recommends against repeal of other necessity of life exemptions.
- (7) The subcommittee recommends that special purpose charitable exemptions be eliminated.
- (7-A) The subcommittee recommends exemptions remain for either: (1) a limited number of general categories such as "health care providers", "educational institutions", and "religious establishments", which are broadly inclusive of the type of entities seeking special statutory treatment today; or (2) reversion to the original but fairly narrow statutory concepts of "hospitals, schools and churches."
- (8) The subcommittee recommends that Maine not extend the sales tax to additional services at this time, with the exception of entertainment and recreation.
- (9) The subcommittee recommends that strong consideration be given to the extension of the sales tax to entertainment and recreation.
- (10) This subcommittee recommends that the sales tax should not be extended to any additional services purchased by businesses.
- (11) The subcommittee recommends that the sales tax should not be extended to services provided by professionals.
- (12) The subcommittee recommends that existing equity provisions not be altered unless the sales tax is extended to repair and installation services.
- (13) The subcommittee believes that no additional sales tax rates should be established and the existing 3 rates should probably be looked at for potential consolidation.
- (14) The subcommittee recommends that Maine conform to the practice followed in most jurisdictions and institute a tax on rentals with a corresponding exemption for the purchase of property for rental.
- (15) The subcommittee recommends that where property is leased for a significant period of time, such as five years, and it is therefore the functional equivalent of a purchase by the lessee, that any exemption which would have applied to the purchase of the property by the lessee will also apply to the rentals.

Subcommittee 2
Property Tax - Education Funding

EXECUTIVE SUMMARY

- (1) With the property tax representing 39% of Maine tax revenues (as compared to 35% from the income tax and 26% from the sales tax) there must be a reduction in the burden of that tax. In particular, the rapid increases in state valuations and the reductions in school subsidies for many municipalities are forcing many Maine residents and businesses to sell their properties. Relieving the burden of the property tax on these Maine residents and businesses is the principal position of this subcommittee
- (2) The subcommittee recommends that a State level Advisory Commission on Intergovernmental Relations be created to study various means of reducing governmental costs at the State, County and Local level. The studies must include at least the following:
 1. Identify and recommend elimination of any areas where duplication of services exists.
 2. Identify and recommend any services that can and should be provided by the private sector instead of the public sector.
 3. Identify and recommend alternative methods of funding governmental expenses.
- (3) Municipalities within a county should have the power to levy local sales taxes if approved by a majority of citizens in a county-wide referendum vote. (DIVIDED)
- (4) The property tax should not be used to fund county government. Jails, the Registries of Deeds and Probate (which represent 3/4 of the cost of county government) are services of statewide importance and nature. These services should either be financed with state funds or, at a minimum, counties should be allowed to retain more of the revenues they generate, particularly from the real estate transfer tax. (DIVIDED)
- (5) The subcommittee recommends that an appropriate body be established to study the feasibility of phasing out the property tax on business and industrial personal property as a long term goal.
- (5-A) If the State begins phasing out the business personal property tax, we recommend that all of the local revenue loss be reimbursed from state sources.

- (6) Municipalities should have the power to charge fees for certain services to any organization exempt from property taxes by broadening the existing statutory authorization allowed in 36 MRSA Section 652.
- (7) To assure greater equity in property taxes, the Bureau of Taxation must update the State of Maine Assessment Manual and maintain its relevance and accuracy as part of the Bureau's ongoing responsibilities.
- (8) The State should continue to seriously study the possibility and implications of adding income and ability-to-pay components to the education funding formula and make appropriate recommendations to the Legislature.
- (9) The State should continue movement towards a goal of reducing reliance on local property taxes for the costs of education by increasing the State share of funding education to 65% as soon as possible.

Subcommittee 3
Business and Environment Taxes

EXECUTIVE SUMMARY

- (1) The subcommittee recommends that as a general policy, when income tax incentives are created, they be established as non-refundable tax credits rather than exemptions or exclusions.
- (2) The subcommittee recommends that when tax credits are created, the purpose for enacting the credit should be clearly stated.
- (3) The subcommittee recommends that the State further investigate the ramifications for Maine of adopting "reciprocal non-retaliatory insurance premium tax" provisions as they exist in Minnesota, New York and Massachusetts.
- (4) The subcommittee recommends an in-depth study of the Bank Franchise Tax and any possible alternatives. This study must include at least the following issues:
 1. The impact of a modified corporate income tax applied to banks and financial institutions in lieu of the franchise tax;
 2. The impact of making the income portion of the existing franchise tax more progressive;
 3. Determine if the asset portion of the existing franchise tax is still an acceptable methodology; and
 4. Determine if banks and financial institutions should be allowed to continue to credit income losses against the tax due on assets in the existing franchise tax formula. (DIVIDED)
- (5) Landfill owners/operators should be allowed a credit against current solid waste management fees due for any waste management fee "accounts receivables" that have been written off as uncollectible losses, as long as they identify the non-payor.
- (6) The Bureau of Taxation should be given the same powers of enforcement for collection of fees due the Solid Waste Management Agency that exist relative to collection of any money due the State.

- (7) The subcommittee recommends that the retail advance disposal fee remain a specific fee at this time.
- (8) The subcommittee recommends that the name "advance disposal fee" be changed. (DIVIDED)
- (9) The subcommittee recommends that the Constitution be amended to allow for a special classification of commercial marine related industry property.
- (10) The subcommittee recommends that the State reimburse municipalities for property tax revenues lost due to farmland and open space classification.
- (11) The subcommittee recommends that the State adopt the federal schedule of depositing employee withholding amounts. (DIVIDED)
- (12) The subcommittee recommends that the State study the impact of using a double-weighted sales factor in the UDITPA apportionment of business income formula.
- (13) The subcommittee recommends the appointment of a highly qualified group to study State spending, with the goal of reducing the overall tax burden in Maine by identifying potential areas where spending can be reduced. (DIVIDED)
- (14) The subcommittee recommends the creation of a task force to review Maine's tax penalty and appeal procedures and the degree of conformity with the provisions of the U.S. Internal Revenue Code.
- (15) The subcommittee recommends that the State study the ramifications of adopting Alternative Minimum Tax provisions that parallel both in form and rate structure the federal Alternative Minimum Tax provisions.
- (16) The subcommittee recommends that the personal property tax for business and industry be phased out over a period of time, provided that municipalities be reimbursed for 100% of any lost revenue.
- (16-A) If the personal property tax for business and industry is phased out, the subcommittee recommends that the Investment Tax Credit also be phased out over the same period of time.

Subcommittee #1

Sales Tax and Sales Tax Exemptions

*Rep. Guy Nadeau, Chair

*Rod Scribner, State Auditor

*John LaFaver, State Tax Assessor

*Steve Deller, U Maine, Orono

Warren Silver, Lawyer

Dr. Edward David, Neurological Institute of Maine

Dan D'Entremont, L.L. Bean

Jim Blumreich, James River Corp.

James McConnon, Cooperative Extension Service

Dale Eichorn, WCSH Television

Charles Micoletau, Lawyer

Roger Pomerleau, Frank Pomerleau, Inc.

Lee Stanley, Cable TV

Bob MacDonald, Auto Dealer

*Committee Member

Subcommittee #1 - Sales Tax and Sales Tax Exemptions

The Governor's Tax Policy Study Committee (Silkman Report, 1987) raised a number of issues requiring additional study. The charge of the Select Committee on Comprehensive Tax Reform offers an opportunity to continue the examination of the sales tax and sales tax exemptions in an effort to address the concerns raised. The specific areas to be studied by the subcommittee include:

1. **"Exemptions by Disease"**
Some exemptions appear to exist only because certain groups asked for them.
2. **"Industry Competitiveness"**
Lack of clear relationship between exemption and competition factor.
3. **"Other Exemptions"**
Some exemptions exist with no apparent major social or economic justification.
4. **"Sunset all Exemptions"**
Should exemptions exist until consciously repealed or should they be eliminated at a specific time unless consciously continued?
5. **Sales Tax on Services**
Should sales taxes be expanded in this area?
6. **Admissions/Amusement Taxes**
Similar to tax on services, but focused only on discretionary, fun things like movies, concerts, bowling, golf, etc.
7. **Gross Receipts Tax**
Should the New Mexico, Hawaii concept be adopted in Maine? A major issue.
8. **Local Option Taxes**
Should municipal or regional sales taxes be allowed?

SUBCOMMITTEE 1

I. INTRODUCTION

The sales tax has been an integral part of Maine's tax structure since 1951. The subcommittee is concerned by the fact that sales tax legislation is sometimes enacted without reference to any established set of tax principles. This often results in a piecemeal approach to legislation, where exemptions or expansions in the sales tax base are enacted during the closing hours of the Legislature, driven by revenue considerations rather than sound tax policy. This in turn erodes taxpayer confidence, contributes to inconsistencies and adds to administrative burdens.

The subcommittee believes that the state should adopt a clear statement of philosophy as to which economic events should be subject to sales and use tax and which should not. This statement of philosophy should result in a sales and use tax law which is fair and equitable, provides reasonable revenue stability and protects and enhances the competitive position of the Maine economy. The purpose of this report is to identify the characteristics of a revenue system which would accomplish this end. While the subcommittee members have differing opinions on how to achieve these objectives, there is unanimity on the philosophical principles outlined in this report and total agreement that adoption of a clear statement requires immediate attention.

II. REVENUE NEUTRALITY

Throughout the period of this study, we have been concerned about revenue neutrality. Some people believed that the individual subcommittees should be responsible for revenue neutrality and others thought only the full Commission should be concerned about it. (This would enable the members to adopt a revenue raising recommendation from one subcommittee and combine it with a tax relief idea from another, for example.) Recognizing that the

subcommittees will not maintain final control over any of their recommendations, we will simply state that if additional revenue is realized from any changes made to bring the sales and use tax law into conformity with the principles outlined in this Report, it should not be used to raise the heavy tax burden which Maine taxpayers currently face, i.e., by creating new programs.

III. SALES AND USE TAX BASE

As a matter of principle and general philosophy, the sales and use tax base should:

A. Not discriminate between economic sectors;

Comment: Any existing discrimination can, of course, be eliminated either by extending the sales tax to transactions which are not currently taxed or eliminating from the sales tax base transactions which currently are taxed.

B. Provide reasonable revenue stability and growth;

C. Be sufficiently consistent in its applications so that taxpayers have reasonable certainty as to what is taxable and what is not taxable;

D. Contain provisions which promote progressivity of the sales and use tax; and

E. Contain provisions necessary to protect the competitiveness of the Maine economy.

IV. EXEMPTIONS

Exemptions contained in the sales and use tax law should be philosophically consistent. Philosophically inconsistent exemptions lead to taxpayer uncertainty and undermine the credibility of the tax system. Further, exemptions should not be enacted unless they have a sound policy basis. While the list below is not necessarily exhaustive, transactions should generally be exempt only if they fall within one of the following categories of exceptions.

- A. Necessities of life exemptions which help promote progressivity in the sales tax law.

Comment: One of the areas involving the greatest amount of confusion and inconsistency is the exemption for food. For example, if a person purchases a pizza and takes it home to eat, there is no sales tax, but if the person instead eats the pizza on premises, a sales tax applies. These types of distinctions have become more significant and less justifiable due to cultural changes, such as the advent of families where both spouses work and the family eats out more than in the past.

The subcommittee recommends that either this exemption be rewritten to eliminate the various inconsistencies or that the exemption for food be repealed in its entirety. However, the subcommittee would oppose repealing the exemption for food unless it is accompanied by an offsetting refundable credit against the Maine income tax. This would maintain the progressivity which the current exemption for food helps promote.

We would also note that such a change should not be undertaken unless there is a high degree of certainty that the refundable credit will be an adequate replacement for the exemption in the case of those individuals for whom the exemption is most important. This means that the credit must be an economic equivalent of the exemption.

The subcommittee was made aware of two methods of crediting residents for increased expenditures when a sales tax is applied to food. One is simply a "dollar per exemption" system. Used in Hawaii, this method allows residents to deduct \$55 per exemption against their income tax liability. While reducing the regressivity of the sales tax system, this methodology in and of itself is not progressive because of the flat rate. That is, the low-income person and the upper-income person each receive the same value for the exemption. However, it is administratively simple.

The second method is used in New Mexico and is very progressive because the value of the exemption credit is variable depending on income. That is, the lower one's income, the higher the dollar value of the exemption credit. In fact, the credit is phased out entirely for taxpayers with taxable income greater than \$16,000. Obviously, this system is much more complicated than the first one.

The subcommittee is concerned about the credit methodology because of the State's disastrous experience with income tax credits during the tax windfall period associated with the Tax Reform Act of 1986. We are also concerned about the recent experience with the property tax circuit breaker program where individuals in need of tax relief failed to apply for various reasons. Elderly people have been confused by the existing circuit breaker forms or are too proud to apply for "welfare". Currently, a large number of low-income Mainers are not required to file an income tax return. As a result, if they have to file a special application in order to receive the refundable food credit, they may not do so for the reasons cited above. Still another concern regarding the credit is that persons entitled to the

credit will have to pay the sales tax during the year and will receive the credit only at the end of the year. This could be an additional burden on low income Mainers.

The subcommittee emphasizes that these tax credit concerns must be studied in depth and measures must be identified to eliminate these potential problems before any action is taken to repeal the exemption for food and institute a new refundable credit.

While the concept of repealing the exemption for food and instituting a credit presents a number of concerns, there are two distinct advantages. First, it would eliminate the inconsistencies under the current exemption for food. Second, it would add to the progressivity of the Maine sales tax law by imposing a sales tax on purchases of food by those who can afford the additional sales tax burden but relieving those who cannot afford the sales tax burden through the credit.

Beyond the food issue, the subcommittee also discussed the possibility of repealing other necessity of life exemptions and instituting a credit to maintain progressivity. These include the exemption for home heating oil and the exemption for the first 750 kilowatt hours of electricity. The subcommittee recommends against this course of action at this time for a number of reasons. First, the other necessity of life exemptions do not present the inconsistencies which currently exist with the exemption for food. Second, as discussed above, the elimination of necessity of life exemptions and the creation of a corresponding credit creates some risk that either the credit will not be designed adequately to compensate low income families for the loss of the exemption or people in the lower income brackets may fail to apply for the refundable credit. Where a credit must compensate for the loss of several exemptions, it becomes more

complex to design appropriate credit provisions and the risk of the credit not performing as desired is increased. If it is desirable to eliminate necessity of life exemptions, we recommend it be done one step at a time, starting with the exemption for food.

B. Transactions which must be exempt due to federal law or state constitutional law.

C. Purchases by the State, political subdivisions or the federal government.

D. Transactions which should be exempt for reasons of administrative convenience.

Comment: An example of such an exemption is the current exemption for casual sales.

E. Exemptions which prevent "pyramiding".

Comment: Pyramiding occurs when a sales tax is imposed on the purchase by a company of an item and the cost of that item must be recovered in the ultimate sale price of property being produced by that company. Purchases which should be exempt to avoid pyramiding would include exemptions for components used in manufacturing, production and pollution control equipment used by manufacturers, items consumed and destroyed in manufacturing, fuel and electricity used in manufacturing, packing materials, etc.

For example, if sales tax were imposed on components used by a manufacturer to produce a product, the sales tax on the components would have to be recovered in the manufacturer's sales price. This would also be true if sales tax were imposed on purchases of machinery and equipment used to manufacture a product which is ultimately sold at retail. In that case, the manufacturer must recover the cost of the equipment, including any sales tax, in the sale

price of its product. For this reason, a truck purchased by an individual for private use should be subject to sales tax, but a truck purchased by a manufacturer and used in production is an intermediate purchase and should not be subject to sales tax to avoid pyramiding. (See Fisher, "State and Local Public Finance", John F. Due, editor, pg. 172.)

Pyramiding is undesirable for a number of reasons. First, it is hard to fashion rational tax policy because it is difficult to identify where the ultimate burden of the tax falls when there is a tax on intermediate purchases. Second, a tax system which pyramids places businesses which are not vertically integrated, such as most small businesses, at a disadvantage.

Under a tax system that pyramids, a vertically integrated business does not incur sales tax on intermediate goods because it produces rather than purchases those goods. In contrast, businesses which are not vertically integrated would incur sales tax on intermediate goods because they must purchase those goods.

As an aside, it is technically incorrect to categorize purchases of the items described above as "exemptions". They are actually more like exclusions from the sales tax base because they are intermediate purchases, the cost of which must be recovered in the sales of the ultimate retail product, not "taxable retail sales" as defined by statute.

F. Exemptions necessary to protect the competitiveness of the Maine economy.

Comment: Preservation of the competitive position of the Maine economy is a sound policy basis for enacting an exemption. This does not mean, however, that all purchases by businesses must be exempt for Maine to be competitive. Examples of exemptions which are necessary for Maine businesses to compete include the exemption for automobiles sold to non-residents, exemptions for equipment and materials used in farming and fishing and the pyramiding exemptions described in subsection E above.

G. Certain Non-profit Organizations.

Comment: Exemptions from the sales tax for charitable organizations date back to the 1950's when the sales tax was first established. One of the most familiar is the statutory exemption for "hospitals, schools and churches". However, the subcommittee notes the proliferation in the same tax law of special purpose exemptions for non-profit corporations in recent years. The result, today, is both inconsistent treatment and the appearance of unfairness. The subcommittee is concerned with the apparent attitude of "why not me too?" This is not a sound basis for policy development. There is also the question of whether the growing number of tax expenditures on behalf of non-profit entities is justified without the normal legislative appropriations process for deciding State expenditures.

In order to achieve greater consistency, the subcommittee recommends that special purpose charitable exemptions be eliminated. In place of these individual, specific exemptions the subcommittee recommends either: (i) a limited number of general categories such as "health care providers", "educational institutions", and "religious establishments", which are broadly inclusive of the type of entities seeking special statutory treatment today; or (ii) reversion to the original but fairly narrow statutory concepts of "hospitals, schools and churches."

V. TAXATION OF SERVICES

A. The issue of applying the sales tax to services has attracted much attention and controversy around the country in recent years. There is a great deal of variation among the states in this area. New Mexico and Hawaii, for example, tax almost all services. Many states, including Maine, tax very few services. New Mexico has had a broad-based services tax since the 1930's. Residents of that state long ago became accustomed to the tax. Further, population centers in

New Mexico are generally a substantial distance from out-of-state competition and there does not exist the competitive concerns that exist in many other states. In contrast to New Mexico, the recent extension of the sales tax to services in Florida and Massachusetts has been surrounded by much controversy.

Proponents of the sales tax on services cite several policy reasons. They point to the fact that the service economy in the United States is now growing much faster than sales of goods and the extension of the sales tax to services would enhance the rate of growth of sales tax revenues. They also argue that during slow economic times there is generally a more moderate slow down in the service sector than in the retail sale of goods and that, as a result, the extension of the sales tax to services would provide for a more stable tax base. In addition, they argue that the taxation of retail sales of tangible personal property without taxation of services favors the service sector over the goods sector.

Those who oppose the extension of the sales tax to services contend that these statements are over-generalizations. They argue that the impact of taxing services on revenue growth or stability will vary from service to service because some services are also very sensitive to economic downturns. For example, landscaping services are probably as sensitive to economic downturns as is construction and, in fact, more sensitive than sales of many other tangibles. Opponents also point out that, while the extension of the sales tax to some discretionary services (such as club memberships or recreation fees), will make the sales tax more progressive, extension of the sales tax to include certain other services would be regressive. For example, this would be the case with car or shoe repair services because lower income individuals are more apt to have older cars or shoes which are in need of repair than are higher income individuals.

Furthermore, opponents doubt whether extensive economic discrimination results from the failure to tax services. There are, of course, instances in which retail sales of tangible personal property compete with retail sales of services. For example, a car owner with a faulty transmission has the choice of purchasing a service in the form of transmission repair or purchasing a new transmission. On the other hand, there are many instances in which such alternatives do not exist. This would generally be true of professional services such as lawyers, doctors and engineers where there is usually not a choice between purchasing the service and purchasing tangible property as an alternative. Finally, the retailer who must collect sales tax on goods sold certainly does not feel discriminated against by the fact that he does not have to pay his accountant or advertising agency a sales tax on the services that he purchases from them.

B. General Recommendations

Taxation of services is clearly a complex area in which policy arguments and principles must be applied on a case by case basis to the service in questions. The New Mexico gross receipts tax has a unique history and has developed a culture of its own. It is not appropriate for Maine. Since policy considerations are mixed, most states do not have a broad-based services tax and the recent experience in Florida and Massachusetts has been less than encouraging, the subcommittee recommends that Maine not extend the sales tax to additional services at this time, with the exception of entertainment and recreation.

C. Entertainment and Recreation

If the sales tax is extended to additional services, it should first be extended to services where there is currently inconsistency and where taxation of the service will make the Maine sales tax more progressive. Currently, the major inconsistency with respect to services is in the entertainment/recreation area. The Maine sales tax presently applies to the rental of video tapes and extended cable television. These entertainment modes, defined as taxable services, compete with other types of entertainment such as movies, sporting events, plays, etc., which are not taxed. In a more general sense, they compete against a broad range of recreational activities such as golf, bowling and amusement parks, also not taxed. Given this existing inconsistency, and the fact that entertainment and recreation are discretionary, the subcommittee recommends that strong consideration be given to the extension of the sales tax to entertainment and recreation.

D. Services Provided to Businesses.

Economists and tax experts draw a distinction between "consumer" services and services provided to businesses so the taxation of services provided to businesses was discussed by the subcommittee. While some economists and tax experts support the extension of the sales tax to those services which might be referred to as "consumer" services, they generally oppose the extension of the sales tax to services provided to businesses. In his presentation to the full Committee, Professor Steve Gold stated that most business services should not be taxed. A recent edition of State Policy Reports concluded that economists' preference for taxing services does not extend to services provided to businesses. (State Policy Reports, Vol. 8, Issue 3, page

7.) This opposition to the taxation of services provided to businesses stems from the fact that it is often difficult to determine the proper taxable event in a series of purchases and sales of goods and services among businesses. Furthermore, concerns regarding pyramiding exist and, in some cases, concerns of interstate competition are involved.

While some services to business are currently taxed, this subcommittee recommends that the sales tax should not be extended to any additional services purchased by businesses such as consulting, advertising, legal, accounting, engineering, installation and construction services, even if the sales tax is extended to consumer services.

E. Professional Services

Services provided by professionals also deserve special note. The subcommittee recommends that the sales tax not be extended to services provided by professionals, such as accountants, doctors, lawyers and engineers, regardless of whether the service is purchased by an individual or a business. The subcommittee reached this conclusion for several reasons. First, we find no strong policy reasons for extending the sales tax to these services. This is not an area where there are currently any inconsistencies in the sales tax law or where there is discrimination between economic sectors. As noted, professionals generally are not in competition with retailers of tangible personal property. Also, purchases of professional services usually are not considered discretionary in nature. Finally, while this is certainly not true in all instances, professional services can often be obtained from out-of-state sources. This presents complex enforcement and competition problems.

F. Current Equity Based Exclusions

The Maine sales and use tax law currently excludes from the taxable sales price certain separately stated charges such as those for installation or repair of the property sold or transportation of the property sold. These exclusions have been in the sales and use tax laws since its initial enactment and are an integral part of sales and use tax law of many states. They are necessary to avoid discrimination. For example, without an exclusion for installation services, a company which sells the property and also provides an installation service would be required to collect sales tax on the installation service. That company would be at a competitive disadvantage in providing the installation service compared to a company which is only in the installation business and, therefore, is not required to collect sales tax. The subcommittee recommends that these provisions not be altered unless the sales tax is extended to these services (which the subcommittee believes should not occur at this time).

VI. TAX RATES

Maine currently has three sales tax rates. The general rate, is of course, 5%. There is a 7% rate applicable to rentals of automobiles and certain rentals of living quarters and a 10% rate applicable to the sale of liquor at licensed establishments. This means that a hotel guest who dines in the establishment could pay a 10% tax on wine, 5% on the meal and 7% on the lodging.

The subcommittee is concerned by the recent addition of a third rate. Some subcommittee members feel that there should be no more than one rate. Those individuals feel that the ability to administer the tax would be greatly enhanced if there were only one

rate. Other subcommittee members feel that two rates are acceptable. Those individuals feel that the existence of two rates does not create any significant administrative problem. They also believe that there may be instances in which the flexibility of a second rate provides the option of taxing at a higher rate transactions which might predominately involve non-residents and/or involve discretionary purchases. While there is disagreement as to whether there should be one rate or two rates, there was unanimity on the subcommittee that three rates is probably too many and that the number certainly should not be increased beyond three rates.

VII. RENTALS

One final area of discussion concerned taxation of leased or rented items. Except for certain short-term rentals, Maine does not tax the rental of tangible personal property. Instead, lessors pay a sales tax on their purchase price of property to be rented. For example, if Company A rents chainsaws, it pays the sales tax on them when they are bought. In this regard, Maine is out of step with the rest of the nation. Most states instead tax the rental payments and exempt from taxation the purchase by the lessor. In this instance, Company A would not pay the sales tax on the property purchased to rent, but would charge the renter a tax of 5% on the rental payment. That is, if it cost \$20 to rent the chainsaw for a weekend, the renter would pay a \$1 tax to Company A. The fact that Maine is out of step in this area leads to considerable confusion, particularly for out-of-state lessors who are not accustomed to Maine's system.

In addition, Maine's current system can lead to very inequitable results in the case of short-term rentals. For example, if a Maine business or individual were to rent property from an out-of-state lessor for 20 or 30 days, sales tax would not be computed with respect to the rental payments for that 20 or 30 day period. Rather, the lessor generally owes Maine use tax with respect to the entire purchase price paid by the lessor for the property. If the

lessor paid \$50,000 for the property, the tax collected as a result of the 20 or 30 day rental period would be \$2,500. Under the terms of the lease agreements, this tax is almost invariably collected from the Maine lessee.

The Committee recommends that Maine conform to the practice followed in most jurisdictions and institute a tax on rentals with a corresponding exemption for the purchase of property for rental. As a matter of fairness, the extension of the sales tax to rentals should not apply to leases entered into prior to the effective date of the legislation making rentals taxable. Further, since sale and lease-back transactions are a frequent form of financing for businesses, particularly smaller businesses, this change should be drafted to ensure that no double tax results in the case of a sale and lease-back transaction. In addition, the tax on rentals should only apply in the case of a true lease and should not apply in the case of leases which are in essence installment sale agreements.

Finally, if the law is amended to require lessees to pay sales tax on their lease payments, exemptions which would apply in the case of a purchase of the property by the lessee should also apply to any rental by the lessee of the property for a substantial period of time. Many small businesses which cannot afford to buy equipment or other property, lease the property for substantial periods. A small business which cannot afford to purchase property would be at a competitive disadvantage if it had to pay sales tax on rentals while another business which can afford to purchase the property can do so tax exempt. As a result, the subcommittee recommends that where property is leased for a significant period of time, such as five years, and it is therefore the functional equivalent of a purchase by the lessee, that any exemption which would have applied to the purchase of the property by the lessee will also apply to the rentals.

Subcommittee #2

Property Taxes and Education Finance

*Sen. Stephen Estes, Chair

*Rep. Clyde Hichborn

*H. Sawin Millett, Commissioner of Finance

*William Hamlin, Hamlin Associates, Inc.

Pat Blanchette, Bangor City Council

Marshall Frankel, Bangor City Council (former)

Leo Martin, Supt. of Schools, SAD 71, Kennebunk

Jim Watkins, Department of Education

George Mayo, General Public

Os Bonsey, Town Manager, Yarmouth

Rosaire Pelletier, Fraser Paper, LTD

Vinnie McLaughlin, Bath Iron Works Corp.

Robert Stevens, Freeport Town Council

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Subcommittee #2 - Property Taxes and Education Finance

A number of specific Education studies have recommended various levels of State participation in the Education funding formula. The Governor's Tax Policy Study Committee (Silkman Report, 1987) was likewise unable to agree on a specific amount of money or percentage of State aid. The charge of the Select Committee on Comprehensive Tax Reform offers an opportunity to continue the examination of the Education funding issue and its impact on the local property tax, in addition to other concerns. The specific areas to be studied by the subcommittee include:

1. **Percentage of State Aid Provided for Education.**
A major issue due to the cost of any significant increase, e.g. 57% to 60% to 65%.
2. **Impact of State Aid on Local School Budgets.**
A major issue.
3. **Education Funding vs Revenue Sharing.**
Should property tax relief be provided through increased aid to Education or more generally through an increase in revenue sharing funds?
4. **Revenue Sharing**
Should the revenue sharing formula be changed? Can any increased funding be directed to specific communities that are providing more services than other communities?
5. **Property Tax Relief**
Evaluation of current relief measures. Type of additional relief programs. Constitutional changes?
6. **Centralized Assessment of Utilities and Railroads**
Should the State have sole responsibility? Should we mandate a specific methodology? Should there be State or regional utility property tax revenue sharing?
7. **Regressivity/Progressivity of Dedicated Sales Tax**
What is effect of a sales tax increase dedicated to property tax relief?
8. **Local Options**
Should local option taxes be allowed?

SUBCOMMITTEE 2

I. INTRODUCTION

The property tax has always been a major component of Maine's tax mix, but the manner in which it is used has made it increasingly visible in recent years. Historically, the "Big 3" taxes (Property, Sales, Income) have been collected in roughly equal shares. However, while the State uses both the sales and income taxes for its purposes, municipalities can only use the property tax as a major source of revenue. Thus, when more revenue is needed for any purpose at the State level, it can be obtained in a variety of ways, e.g. increasing tax rates, expanding the tax base, keeping inflationary revenue growth, etc. It is this variety and flexibility that allows the State to collect additional revenue from different sources at different times without a significant or obvious impact on any one segment of the population. On the other hand, when municipal costs go up, the only real source of revenue is the property tax payer. This sole source aspect causes people to focus on the issue and results in a perception that property taxes always go up while income and sales taxes simply change at the individual level.

Adding to the perceptual problem is the fact that education costs, State and federal mandates and federal cutbacks have all caused the historic equal mix to shift dramatically. Almost 40% of

all tax revenue generated in the State now comes from property taxes, while income taxes account for 35% and sales taxes about 25%. The problem is exacerbated when one realizes that property taxes are the most regressive of the three. That is, if you own property of a certain value, you have to pay taxes at the same rate as everyone in the municipality regardless of your ability to do so. Income taxes are only paid if one has taxable income, and even then, the rates vary according to the level of income. Sales taxes are paid on the value of any taxable item, but there is a voluntary aspect associated with this tax (one doesn't have to buy many items subject to tax) and alternatives are available, i.e. a \$10,000 car vs a \$30,000 car, that can reduce the tax impact. Given that the "worst" tax now generates the largest share of State tax revenue and has for a few years, it is clear that the property tax is increasingly burdensome.

This subcommittee looked at many issues as part of its statutory change. We reviewed existing tax relief programs, past areas of concern and the alternatives discussed to address them and some new proposals that may provide future help. Throughout our discussion we focused on the changing mix in tax collections and realized that rapid increases in State valuations coupled with reductions in school subsidies meant that many Maine residents and businesses were selling their properties as a last resort. Relieving the burden of the property tax on these Maine residents and business is the principal recommendation of this subcommittee.

II. THE PROPERTY TAX SITUATION

Property taxes in Maine are raised to pay for everything from municipal operations to county operations to education funding and State programs and mandates. Unlike other parts of the country where each of these levels of government effectively raise their own taxes, New England municipalities generally lump all these expenditures into a single local tax bill. While administratively simple, this methodology makes the property tax and by default, the municipal officials, the apparent cause of the problem. Obviously this is not true and municipal officials are the first to indicate that many of the expenditures are passed down to them with no opportunity for change. More and more, local town councils and boards of selectmen are blaming the school boards and county commissioners for increasing costs without considering the impact on taxpayers. These latter boards blame the State for raising the costs of education and jail administration beyond any reasonable expectation. And the State simply says it is only doing what the people want.

The subcommittee believes that there is plenty of blame to go around and that it is time to stop blaming anyone in particular. Pointing fingers or just saying "we have to do it" or "you have to do it that way" doesn't help the situation and can even cause more damage to an already very tenuous relationship. This will be especially true as expenditure levels continue to rise in an

economy that is currently faltering. Therefore, the subcommittee recommends that a State level Advisory Commission on Intergovernmental Relations (ACIR) be created to study various means of reducing governmental costs at the State, county and local level.

We recognize that similar groups have been formed in the past. Unfortunately, they have usually only been "one-time" efforts of various select commissions, study groups or legislative-municipal collaborations. While their recommendations have been many, their successes have been few. And even then, their impact rarely lasts longer than the existence of the special study group. That is why a full time, independent and ongoing organization like an ACIR is critical to property tax reform.

Many states have already moved in this direction, following the lead of the somewhat successful national ACIR. Highly qualified, concerned individuals representing all levels and sizes of government are able to meet, discuss, consider and recommend changes in governmental operations that can benefit everyone. More importantly, they can do so removed from the politics and practices of any single government entity, presenting independent and non-partisan viewpoints that are oftentimes lacking in other groups such as municipal associations, county associations and even legislative committees.

When the state ACIR is formed and appropriately staffed (we leave the decisions about the actual form, style and make-up of the commission to the appropriate committee of the Legislature), the subcommittee recommends at least three areas of immediate concern be reviewed. All of them relate to reducing costs. While this general theme is only a part of an effective ACIR, we believe that it is the best place to begin. The recommended study issues are:

- A. Identify and recommend elimination of any areas where duplication of services exists.

Comment: Some work has already been done here. State takeover of county jails is one area that has been discussed, but can only be looked at by an independent group. When this issue was initially proposed, the county organizations viewed it as a State power grab while the State viewed the opposition to the idea as nothing more than sheriffs protecting their own little fiefdoms. Lost in this negative rhetoric was any merit the proposal may have. Similarly, any discussion of state police and sheriff patrol duplication breaks down rapidly when it comes up between the interested parties. These areas and others should be looked at independently.

- B. Identify and recommend any services that can and should be provided by the private sector instead of the public sector.

Comment: This prioritization of government services is a fairly recent area of concern. Most often focusing on jails

and prisons, the issue can possibly include trash collection, recreation, parking facilities, recycling efforts, etc. Certainly the jury is still out on whether these measures actually reduce government expenditures. However, the question can only be answered by a thorough, in-depth review of specific instances in Maine. Again, only an independent, unbiased organization should make the tough decisions.

C. Identify and recommend alternative methods of funding governmental expenses.

Comment: This area can approach the revenue side of the equation, but our focus is primarily reducing expenses that must be paid for through the property tax. Be it user fees, cost sharing, "optional" mandates or whatever, someone has to find other means of funding government services. An ACIR is the perfect choice.

Finally, the subcommittee wishes to highlight that each of the above points specifically state "identify and recommend" alternatives. Too often in the past groups have studied issues, only to stop short of making a recommendation. This can happen for a variety of reasons, but we believe that an ACIR type organization, that is permanently established, can overcome the aversion to recommend solutions to increasingly severe problems.

III. Particular Problems with Property Tax

Many studies in the past have addressed problems with the property tax. This subcommittee reviewed the most recent ones, including the Speaker's Select Committee on Property Tax Reform (Nov. 1986) and the Governor's Tax Policy Study Committee (Nov. 1987). We discussed all of the existing property tax relief mechanisms, continuing problems with State valuation, tax administration and the impact of the property tax on Maine residents and businesses. While we chose not to speak to every one of these issues, our silence should not be interpreted as total agreement or disagreement with existing policies. Rather, we have recognized that some issues are simply suffering growing pains and just need time to develop before major alternatives can be discussed. Other issues could not be adequately addressed within the time frame of this study and were set aside, hopefully to be looked at by the ACIR recommended earlier. Still others were noted and passed over.

For example, the recent creation and delay of a Homestead Program and a major expansion of the Circuit Breaker Program are two areas that generated considerable subcommittee discussion. Some members argued for narrower eligibility requirements under the circuit breaker while others discussed lowering the maximum benefits and expanding the eligible beneficiaries. Some members wondered why there were still two circuit breaker programs (elderly and low-income). Some members argued for elimination of the Homestead Program before it starts up, while others felt that if the funding level were made meaningful, the program would be the best thing ever

devised for property tax relief because every taxpayer would get something. Everyone wondered why both of these programs couldn't be administered much more simply! The final result of this subcommittee's discussion is a recognition that these programs will eventually need to be amended or changed, but now is not the time. The programs are still too new to effectively tinker with them.

There are, however, some issues that need restating. The first is not necessarily a major concern, but perhaps that makes it all the more curious as to why past recommendations have not been implemented. Many towns in Maine have a part-time assessor or board of assessors. These people, by and large, are not professionals by any stretch of the imagination. They are good people trying to do a good job and rely on various sources of information for help. A major source of help in Maine is the State Assessment Manual. It is also a source of frustration.

Simply put, the manual is outdated. Last revised in 1979, the current version doesn't even contain information about newer building techniques such as 2" x 6" construction, changes in insulation material types and methodologies or improved plumbing and electrical materials. Since the purpose of the manual is "to identify accepted and preferred methods of assessing property", many towns find it useless when trying to determine the value of new or improved properties. The law does allow municipalities to use "another professionally accepted manual or procedure" but it is

believed that many assessors, especially part-timers in small towns, prefer a Maine specific manual.

Since the only real problem is a lack of recency, the obvious solution is to update the manual. In the two most recent sessions of the Legislature, legislation has been introduced to fund just such an updating. However, with an estimated cost of \$200,000, this separate legislation has failed every time. Thus, the Bureau of Taxation says that it has been willing to update the manual but has been unable to obtain funding to do so. A past Commission strongly disagreed with this rationale as did some members of this subcommittee. Title 36 MRSA, §331, enacted in 1985, specifically states that "the State Tax Assessor shall maintain and periodically update a State assessment manual...". This clearly makes updating an ongoing administrative expense of the Bureau of Taxation which should be included as part of the Administration's budget request. Therefore, separate "extra cost" bills should not have to be introduced by the Bureau where they have to compete with hundreds of other bills for limited funds at the end of a session.

The "ongoing" maintenance and updating argument notwithstanding, the subcommittee has been assured that a Part II request (new or expanded program) for funds will be made during the upcoming budget process. We strongly encourage both the Legislature and the administration to provide the necessary funding. To assure greater equity in property taxes, the Bureau of Taxation must update the State of Maine Assessment Manual and maintain its relevance and accuracy as part of the Bureau's ongoing responsibilities.

The second restated issue concerns county government. The subcommittee recommends that the property tax not be used to fund county government. Jails, Registries of Deeds and Probate Court represent about 75% of the cost of county government but are services of statewide importance and nature. As such, they should be financed entirely from State sources, if not actually taken over and run by the State (see earlier recommendation). Remaining functions of county government, if necessary, could be financed through existing sources of revenue (user fees, real estate transfer tax, contractual arrangements) or some broader based tax sharing methodology.

If this idea cannot be implemented at this time, the subcommittee recommends that counties should at least be able to retain more of the revenues they generate, particularly from the real estate transfer tax. This recommendation is based partly on the belief that any dollar other than a property tax dollar is preferable to fund county government. Other cost sharing formula programs exist too. They include the Jail Operations surcharge (an additional amount to be paid on fines and penalties) and the County Corrections Improvement Account. The subcommittee would encourage any study of the revenue retention issue to include all potential sources of additional revenue.

Opponents of these two recommendations believe that the state is just as burdened financially as most municipalities. Thus, while

allowing counties to keep more revenue decreases the need to collect property taxes, it only increases the financial pressure on the State. Even though the State has a broader range of revenue sources, it is not easy to give up any particular source, such as the real estate transfer tax or the jail operations surcharge, no matter how large or small. Therefore, unless new or expanded sources of revenue are found, some members of the subcommittee do not support the recommendation that counties be allowed to keep more revenues or transfer certain programs to the State.

The third property tax "issue" has only recently developed. Most property tax relief measures have been geared towards residents and residential properties. Maine businesses have been hit just as hard by property tax increases but have benefitted only indirectly from some relief programs. This is beginning to have a negative impact on business location decisions, economic development issues and plant and machinery improvements. Since many states do not tax business and industrial personal property, Maine is at a significant disadvantage in this regard if the industry is competitive in various states. A prime example is a paper machine valued at \$150 million. If a company can put the machine in a mill in Georgia with little tax consequence vs its location in Maine with a corresponding tax bill of \$2 million, Georgia has a distinct advantage, all other things being equal.

Most studies have historically shown that tax policy is not a high priority for most businesses. Some recent articles have

indicated otherwise. The subcommittee heard testimony that it is certainly becoming an issue as states compete for industry in a declining economy. Maine cannot afford to lose any of its manufacturing base if we are to grow in coming years. Therefore the subcommittee recommends that an appropriate body (ACIR?) be established to study the feasibility of phasing out the property tax on business and industrial personal property as a long term goal.

As a correlative recommendation, the subcommittee believes that if the State does begin phasing out the business personal property tax, all local revenue losses should be reimbursed from state sources. The most recent data available indicate that business and industrial personal property is valued at approximately \$5 billion in Maine. Using an "average" mill rate of 17, the lost revenue to municipalities would be \$85 million. The Constitution requires at least 50% of this loss to be reimbursed. We do not believe that a State decision to enhance industrial development should result in a \$42.5 million loss in revenue for Maine's towns and cities even if it is done so gradually.

IV. PROPERTY TAX ALTERNATIVES

As stated earlier, the only major source of revenue available to municipalities is the property tax. This means increased expenditures automatically result in increased property taxes and has been a particular bone of contention for municipalities for years. Cities and towns have long argued that with a given level of necessary expenditures, any dollar of revenue obtained elsewhere is

one less dollar needed to be collected through the property tax. Often times, additional sources of revenue could be expected to grow enough to cover increased expenditures without an increase in property taxes. If applicable to municipalities, they would begin to approach the same variety and flexibility in revenue collection enjoyed by the State, thereby decreasing the burden imposed by the property tax.

Past recommendations to expand revenue sources available to municipalities have been mixed. Some studies have supported certain ideas, others have not. This study is no different. The subcommittee is divided on the most frequent suggestion for additional revenue - the local option sales tax. However, a majority supports the recommendation that all municipalities within a county be required to levy a local sales tax if approved by a majority of citizens in a county-wide referendum vote.

The proponents argue that this is the best alternative available. It is relatively easy to administer, it can be a substantial amount, it is directly related to a major cause of municipal expenditures, i.e., a central shopping district draws many non residents to a municipality but only property taxpayers pay for the police, fire, infrastructure, etc. needed to support the district, and it is reasonably stable. While the subcommittee recognizes some potential problems and has chosen not to recommend the local rate or any of a wide variety of methods of sharing the

local amount, if necessary, we do believe that the issue must be addressed now. Many other taxing jurisdictions allow such a local option with little or no effect and Maine should be no different.

The opponents are just as strong in their belief that the local option sales tax is not a viable alternative for Maine. We have had significant experience with the border war issue between Maine and New Hampshire regarding sales taxes. Adoption of this recommendation could multiply the border war zones by 16 if all counties passed referenda or chose not to pass one in an effort to attract shoppers from outlying areas. It does not appear to be fair for some cities to "charge" residents for the privilege of shopping there and the spin-off and economic multiplier effect of dollars spent in one area already compensate municipalities for service expenditures. The existing tax base is too unevenly distributed throughout the State for this option to ever be fair. Finally, depending on the actual format of the local option, the tax could be an administrative nightmare for retailers, consumers and the State.

The second alternative source of revenue discussed by the subcommittee was the use of fees for services. This idea is not new and has generated some support in the past, but nothing has been changed. Current law allows cities and towns to charge fees in only very narrowly defined circumstances. Specifically, they can only charge fees for services to any organization owning residential properties currently totally exempt from property taxation, yet used to provide rental income (36 MRSA, §652, sub-§6). Even then, the

fees cannot exceed 2% of the gross annual revenues of the organization.

Municipalities argue that any organization benefits from police and fire protection, road maintenance and traffic control as much as residents. They should, then, be required to share in the costs of those services. This subcommittee agrees. Therefore, we recommend that municipalities be given the power to charge fees for certain services to any organization exempt from property taxes by broadening the existing statutory authorization in 36 MRSA §652. Allowing municipalities to request voluntary payments in lieu of taxes from exempt organizations has not worked. We must let them charge fees for services.

A few other revenue ideas were also discussed. The county revenue options were previously presented. A local option income tax exists in other states, but was disregarded by the subcommittee. We talked about amending the existing general revenue sharing formula by either increasing the share of sales and income taxes available to municipalities or eliminating state valuation from the formula. Again this option was not formally voted in or out by the subcommittee. We hope that future groups continue to look at these areas, though, in an effort to reduce municipal reliance on the property tax.

V. EDUCATION FUNDING

At least some aspect of education funding, if not the entire formula, has been studied or reviewed every year since its inception following repeal of the uniform property tax. Some years, two or three different studies were conducted and this year was no different. The subcommittee spent a great deal of time reviewing the history of education funding in Maine and comparing our standing and process with that of other states. We discussed a number of concerns about the rapid increase in education costs and State mandates and the resulting impact on property taxes. A national expert was called in and pointed out that many states were facing the same kinds of problems as Maine, but many of them suffered additionally from numerous school finance lawsuits. This pending litigation was seriously compounding the problem of funding education throughout the country. Maine had a significant advantage over these other states because our funding formula could serve as a model system for apportioning state aid.

Throughout this discussion, two issues continued to surface that have been raised before. The first point is that the current formula in Maine is designed to work best with a State share component of at least 65%. Unfortunately, the State is only providing about 57% (excluding teacher retirement funding) at this time. This doesn't hurt many of the "poorer" districts too much because the 57% figure is a statewide average and many of these

smaller districts are receiving 70% to 80% or more in state aid. The high valuation districts, on the other hand, receive very little, if anything, from the State. Many of these cities or towns would receive something if the state share were funded at an average of 65%. Of course, this assumes that the difference between 57% and 65% would be paid for in new money so as not to disrupt the existing equity that results in poorer districts receiving the amounts they do. We recognize that the cost to do this is substantial (about \$100 million in FY 92-93) but the present situation can only deteriorate further if additional assistance is not provided. Therefore, the subcommittee recommends that the State continue movement towards a goal of reducing reliance on local property taxes for the costs of education by increasing the State share of funding education to 65% as soon as possible.

The second point is somewhat related to the first. That is, high valuation districts receive little or no State aid for education on the theory that they can afford to raise enough taxes locally to provide a certain standard of education. The impact on these towns is that education funding represents 50%-75% of an individual's property tax bill. As stated earlier, the property tax is the most regressive tax because it has very little relationship with an individual's ability to pay. This catch-22 has resulted in a great deal of frustration and resentment towards education on the part of homeowners and municipal officials who believe that they are being forced to pay beyond their ability for something over which they have minimal control.

The last few years have seen increased concern about income and ability to pay components being added to the education funding formula. These studies have shown that a shift in aid does occur between low valuation and high valuation districts when per capita income figures are used. However, people have been unwilling to incorporate the changes at the present time because of the implied "winner" and "loser" aspect associated with it, and new money has not been available to hold the low value districts harmless. Granted, this new equity issue is confusing and goes well beyond past interpretations of what is fair and equitable in education funding. Yet people living in high valuation districts along the coast or in southern Maine are being hard pressed to pay the property taxes required to maintain the historic distribution. When they see studies that indicate a "fairer" method of sharing state aid that begins to address their concerns, they want and deserve action.

We know this issue is particularly troublesome for everyone involved at the State and local level. The groundwork has been laid and more studies are ongoing in this area. The subcommittee recommends that the State continue to seriously study the possibility and implications of adding income and ability to pay components to the education funding formula and make appropriate recommendations to the Legislature. There are some promising indications that such a system can be implemented eventually. We do not want this area ignored any longer.

Subcommittee #3

Business and Environment Taxes

- *Rep. Walt Whitcomb, Chair
- *Barry Larman, UNUM
- *Richard Silkman, Director, State Planning Office
- *Bonnie Post, General Public
- Rep. Susan Dore
- Jane Saxl, Bangor City Council
- Ronald Smith, Key Bank
- Susan Mitchell, Doyle and Nelson
- Ken Quirion, Maine Merchants Association
- David Hawkes, KPMG Peat Marwick
- Richard Simoneau, CPA
- Merle Bragdon, Preti, Flaherty, Beliveau, Pachios
- Glen Wilson, PA
- Tim Zorach, Maine Audubon Society
- Kit St. John, Pine Tree Legal
- Robert Carroll, Champion Paper

*Committee Member

Subcommittee #3 - Business and Environment Taxes

Make-up of the financial industry and regulation of various financial services has changed dramatically in recent years. Special treatment of certain industries may not be justified any longer. The Governor's Tax Policy Study Committee (Silkman Report, 1987) identified the Insurance Premium Tax and the Bank Franchise Tax as areas of particular concern. The charge of the Select Committee on Comprehensive Tax Reform offers an opportunity to continue the examination of these issues in addition to others. Specifically, the subcommittee shall review the following:

1. **Insurance Premium Tax**
Is this methodology still justified? Is the rate appropriate? Is it applied equitably?
2. **Bank Franchise Tax**
Is this methodology still justified? Is the formula still appropriate?
3. **Railroad Excise Tax**
Is this methodology still justified? Is the formula still appropriate?
4. **"In-lieu of" Concept**
Should the special taxes in 1-3 be continued or should we use a corporate income tax (or other) methodology?
5. **Tax Credits**
Does the State get an adequate or appropriate rate of return on its allowance of various credits? Are the credits justified?
6. **Environmental Concerns**
Are environmental facilities sales tax exemptions justified? Should we adopt "pollution taxes" that are applied at the source?
7. **Waste Management - Tax Policy**
Can these two issues be combined, i.e., solve one problem through use of the other? Should the State expand its regulatory power or provide economic incentives to local governments? Are user fees more or less appropriate to address solid waste issues than broad based taxes?
8. **Environmental Tax Credits**
Are Tree Growth, Farm and Open Space programs effective? What is their impact on local governments? Should solid waste facilities be included?

SUBCOMMITTEE 3

I. INTRODUCTION

In addition to the State's major sources of revenue (Income, Sales Property taxes), there are many other pieces of the overall tax policy that impact specific organizations and landowners. After assigning the sales tax and property tax issues to other subcommittees and deciding not to do an in-depth review of the income tax due to its very recent overhaul, the Select Commission on Comprehensive Tax Reform created Subcommittee 3 to review some of those specific areas. This resulted in numerous presentations by various industry representatives and a rather wide ranging review. Some policy areas were looked at and determined to be relatively sound. Others were reviewed and determined to be complex enough to warrant much more study as a single issue. In fact, we found that some states with more or less permanent tax reform commissions did exactly that, i.e. study one or two issues over the course of a year and then move on to others.

Subcommittee 3 looked at the three largest tax sources where payments are made in lieu of normal corporate income taxes. Environmental concerns relative to tax policy and environmental property tax credits were reviewed, as was the very recent waste management-tax policy interaction. Finally, a number of general taxation administrative issues were discussed and recommendations were presented in some of these areas.

The subcommittee believes that further study of many of these issues is warranted. The Governor's Tax Policy Study Committee (Silkman Report, 1987) raised some questions. This commission carried the process one step further and we are convinced that with enough time and resources, future groups can reach consensus as to appropriate action.

II. INSURANCE PREMIUM TAX

Maine currently generates about \$45 million from the Insurance Premium Tax for the General Fund. This tax, set at 2% of all gross direct premiums written in the State for insurance of life, annuity, fire, casualty and other risks, is paid in lieu of an income tax. Nearly every state uses the same or similar methodology and most states have the same rate as Maine. In those states with different rates, the effect is somewhat offset by a unique exemption from anti-trust statutes provided to the insurance industry. Retaliation is legal for this industry in terms of setting rates due states.

Briefly, every state sets the tax rate charged companies selling insurance in that state, whether or not the company is physically located there. Almost every state has statutory language that says, in effect, if your state charges an insurance company from my state a rate higher than my state charges a company from your state, my state can raise the rate charged your state's company doing business here to the same amount your state charges my company. For example, the premium rate for accident insurance in Texas is 2.5%, which is the amount any Maine based company would have to pay for sales in

Texas. Due to reciprocity language, this is not a problem because Maine can legally charge any company from Texas 2.5% of its premiums on sales in Maine, the same rate Texas charges Maine companies. It appears that this retaliatory concept has been responsible for keeping the rate for most states at or near 2%.

In the course of our review, a different twist to insurance taxation was presented. Termed "reciprocal non-retaliatory insurance taxation", the concept was suggested by the Council of State Governments in the late 1970's. If adopted, it provides that one state will not retaliate against another state on premium taxes if that state agrees not to retaliate against the first state. Apparently the concept has not spread rapidly because its major impact is on those very few states that charge insurance companies a corporate income or franchise tax in addition to the premium tax. Under strict retaliatory language, companies in these states would be penalized in other states if the combined tax liability were greater than just the premium tax.

Minnesota was the most recent state to adopt the law. New York and Massachusetts are the others, and three states (Hawaii, New Mexico and North Carolina) do not impose retaliatory taxes. Thus, the concept can only be applied in these six states and its impact on other states is difficult to assess. Minnesota realized a short term reduction in revenues, with the hope of higher revenues in the future. Because Maine is very similar to the above states in overall tax burden and per capita premium taxes, the subcommittee

recommends that the State further investigate the ramifications for Maine of adopting reciprocal non-retaliatory insurance tax provisions as they exist in Minnesota, New York and Massachusetts.

III. BANK FRANCHISE TAX

The second largest source of taxes in lieu of income tax is the bank franchise tax. Based partially on net income and partially on asset valuation, the tax was devised to overcome a problem with an interpretation of the U.S. Constitution in *Memphis Bank and Trust Co. vs. Cramer* regarding bank taxes. Currently the rate in Maine is set at 1% of net income plus \$.08 per \$1,000 of assets. Unlike the insurance premium tax, there is no real consistency among the states on bank taxes. Rates vary considerably, as do the definitions of taxable base. Out of state ownership of financial institutions has further complicated the issue by adding apportionment considerations to the amount and type of income subject to tax in a particular state.

The subcommittee discussed many issues regarding the franchise tax and asked a number of questions of industry representatives in attendance at meetings. We also recognized that many other states have studied bank franchise tax issues alone over the course of a year rather than as part of a larger study, in an effort to ensure fairness and appropriate public policy. Given insufficient time and resources to do a major review at this time, the subcommittee recommends an in-depth study of the bank franchise tax and any possible alternatives. Issues of particular importance to us are:

A. The impact of a modified corporate income tax applied to banks and financial institutions instead of a franchise tax.

Comment: As stated earlier, the existing franchise tax was developed to overcome an unconstitutional definition of income liable to tax. Some members believe that redefining "income" could also overcome the constitutional problem and result in a different form of taxation. Significantly more data is needed in order to adequately determine the effect on revenue under various "what if?" scenarios.

B. The impact of making the income portion of the existing franchise tax more progressive.

Comment: Some states vary the bank franchise tax rate according to the amount of income earned. For example, Delaware has a bank franchise tax that ranges from 2.7% to 8.7% of taxable income. Maine's corporate income tax is progressive in the same way. The subcommittee believes there may be some merit to a variable rate in the franchise tax formula.

C. Determine if the asset portion of the existing franchise tax is still an acceptable methodology.

Comment: Maine happens to split tax liability between income and assets. The historic rationale was an effort to guarantee some state revenue every year, regardless of earned income. Since many states do not use assets in their franchise tax formulae, there is some question regarding its validity in Maine. We did not want to change

this format, however, without further study and analysis of what an income only tax would do to the State revenue stream.

- D. Determine if banks and financial institutions should be allowed to continue to credit income losses against the tax due on assets in the existing franchise formula.

Comment: If a two part franchise tax will continue in the future, some members believe it will need some minor adjustments. Specifically, existing policy allows banks to offset asset portion liability with income portion losses. This completely ignores the constant stream of revenue argument used to devise the two part formula in the first place. Therefore, if the in-depth study indicates continued support for a two part formula, we recommend looking at this issue.

Many members of the subcommittee felt strongly that the existing franchise tax policy was sound and didn't need to be changed. A slim majority felt otherwise. This evenly divided support seems to be enough of an indication that further study is warranted.

IV. WASTE MANAGEMENT - TAXATION POLICY

A fairly recent but severe issue in Maine regards waste management policy. A newly created agency to deal with the problem

tentatively discussed a special tax on certain items to fund its operations. After much debate and discussion, a fee schedule was adopted, avoiding the tax issue temporarily. However, many people either fail or choose not to distinguish any difference between fees and taxes. For this reason, subcommittee 3 was assigned the task of revisiting the situation.

The committee reached early consensus that the fee system should be given time to develop before any changes were recommended. Too often, adjustments are made before a new process or procedure can mature and real problems can be identified. We heard testimony that funding the Solid Waste Management Agency may become a problem in the future in terms of revenue expectations. We prefer to withhold any fee or tax recommendations subject to what actually happens in a year or two rather than what might happen based on a few months experience. Therefore, we recommend that the retail advance disposal fee remain a specified fee at this time.

The subcommittee further recommends, however, that the name "advance disposal fee" be changed. Many municipalities charge disposal fees on the same types of goods that the State fee is based on. The potential confusion caused by paying the State fee for disposal when an item is purchased and the municipal fee when an item is disposed is too great to allow the name to continue without change. Even though there is much precedence in this area, e.g. state and municipal fees charged simultaneously for victualers

licenses, amusement licenses, health inspections, etc. the subcommittee believes that this particular instance is different. We do not recommend an alternative name; we do recommend a name change.

Two lesser issues in this area concern fees charged by landfill owner/operators to waste haulers which are supposed to be passed on to the Waste Management Agency. The subcommittee believes that the Bureau of Taxation should have the same powers of enforcement for collecting these fees that it has for collecting any money due the State. Apparently, collections have been "slow" since the fees were established. If these problems continue to grow, the Waste Management Agency would have to create an entire enforcement/collection department. The subcommittee does not think that this would be an efficient use of resources to the extent that it would duplicate existing enforcement activities at the Bureau of Taxation.

Secondly, the system that exists with sales tax collections and the way retailers can credit transfers of that revenue with any written-off, uncollectible amounts should apply the waste management fees. That is, a retailer can currently deduct from one month's revenue collection any "bad debt" amounts that are written off as uncollectible but had been "paid" by the retailer in a prior month. By removing ultimate liability for the fee from the landfill operator and transferring enforcement to the Bureau of Taxation for collection by identifying the non-payor who was liable

for the fee, it is believed that the administrative process wouldnot be duplicative between the bureau and the Waste Management Agency any more than absolutely necessary.

V. ENVIRONMENTAL CONSIDERATIONS

As part of the subcommittee's review of environmental tax credits, two specific recommendations were made. First, the subcommittee recommends that the State reimburse municipalities for property tax revenues lost due to farmland and open space classification. Of the three "current use" valuation distinctions included in the Constitution (Tree Growth; Farmland; Open Space), only tree growth losses are reimbursed. That is, as a matter of State policy established by the Constitution and statute (36 MRSA §563 et. seq.), the value of land designated to grow trees is set by the State Tax Assessor at a level other than "just value". The difference between the "just value" and the tree growth assessed value results for the most part in a loss of property tax revenue for the municipality. The State reimburses these towns for 90% of their lost revenue (subject to certain minor adjustments).

The subcommittee believes that farmland and open space classifications are no different than tree growth. They represent State policy decisions that are now funded entirely by the cities and towns. This is wrong and must be changed as soon as possible. If the State is going to allow differences in assessed valuation for some types of land, it must pay the price for its policy implementation.

The second recommendation in this area is to add a new category of special classification. The subcommittee recommends that the Constitution be amended to allow for a special classification of commercial marine related industry property. The State has a long history of treating agricultural and aquacultural interests similarly. State grants, sales tax exemptions, etc. are all provided to both sectors. Only the property tax area has remained separate. Given the incredible growth in assessed valuation of coastal properties, many Maine residents whose families have fished for generations have found themselves unable to afford to stay on the very land that provides them access to their livelihoods. Fish piers and lobster pounds are being lost to developers continually due to incessant tax increases. We believe something must be done before it is too late to save this extremely important industry and the people it supports. Obviously the subcommittee would include the municipal reimbursement issue in this idea if it is accepted by the full Commission, the Legislature and the people of the State of Maine.

VI. GENERAL ISSUES

Subcommittee 3 discussed a number of issues beyond the specific ones identified above. Some of these concern the income tax and some deal with administrative procedures surrounding tax issues and policy. In terms of general policy, the subcommittee recommends that when income tax incentives are created, they be established as non-refundable tax credits rather than exemptions or exclusions. We believe that this specific dollar for dollar trade-off is much

more beneficial to the taxpayer and ties the benefit directly to the taxes otherwise due. It would also benefit only those who have a tax liability in a given year, which may lessen the economic loss to the State or at least spread out the impact over a period of time through carryback - carryforward language in the statute.

We also recommend that when tax credits are created, the purpose for enacting the credit should be clearly stated. During our review, the issue of corporate disclosure arose, in which it was stated that tax credits are given to encourage certain types of behavior. The Committee identified other reasons for creating tax credits, including consumer protection, equity and competitive industry concerns. The disclosure issue was defeated by the subcommittee, but in an effort to ensure complete understanding about why a particular credit was in fact established, we made this recommendation. We hope such a statement will enhance both compliance with and enforcement of the credit.

Another administrative issue concerns deposits of employee withholding amounts. Currently, any person required to withhold taxes must pay the amount withheld to the assessor or his designee quarterly (by the 21st of the month following the close of the calendar quarter). The subcommittee is aware of some employers who must file federal withholding amounts as quickly as three days after receipt. Many others file much more frequently than quarterly. Since these companies are filing the federal reports anyway, we do not believe it would be administratively burdensome

to most businesses to file the State reports at the same time. Therefore, the subcommittee recommends that the State adopt the federal schedule of depositing employee withholdings. At some point in the future we may investigate the possibility of a State depository system similar to the federal government's too, but not at this time.

Lastly, the subcommittee recommends the creation of a task force to review Maine's tax penalty and appeal procedures and the degree of conformity with the provisions and policies established in the U.S. Internal Revenue Code. Court decisions, existing State policies, recent enactment of a Taxpayer Bill of Rights and adoption of much stricter penalty provisions (as part of the amnesty follow-up enforcement) have all combined to cause a great deal of concern and confusion among tax practitioners, lawyers, accountants and taxpayers. Some members of the subcommittee believe that strict compliance with the federal provisions and administrative procedures would significantly reduce most problems and certainly go a long way towards avoiding some others altogether. The members were not sure about how serious a problem exists now and did not feel comfortable making recommendations in this somewhat specialized policy area. For this reason, the recommendation for further study, by those specifically affected most often, was made.

Regarding the income tax, two more studies are recommended. As stated much earlier, the Commission decided not to study the income tax per se because it had been fairly recently overhauled. Much

discussion occurred in this area anyway because of the make-up of this subcommittee and the fact that income taxes are a large part of "business taxes" paid. Without enough time to thoroughly review every one of its actual charges, the subcommittee could not easily expand its review to include additional concerns. Therefore, when specific study topics are being identified for future groups, we would include the following:

- A. The subcommittee recommends that the State study the impact of using a double-weighted sales factor in the UDITPA apportionment of business income formula.

Comment: Federal law prohibits states from taxing certain business transactions under certain conditions. With the rapid rise in multistate corporations, however, the lines of demarcation are quite fuzzy and can shift among the states according to each state's determination of taxable events. In an effort to avert problems that have a negative impact on states' revenue or cause businesses to act in a manner that they otherwise might not, many states have joined the Multistate Tax Compact (MTC). These states follow the regulations established by the Uniform Division of Income for Tax Purposes Act (UDITPA) when apportioning income for state tax liability.

The most common apportionment formula to allocate income to a state includes three factors: sales, property and payroll. The formula adds three fractions together to determine the percentage of income subject to tax.

The fractions consist of state specific amounts for numerators, i.e., sales in the state, property in the state and payroll in the state, divided by the total amount of sales, property and payroll companywide. UDITPA assumes equal weighting for all three factors, but this does not automatically happen because membership in MTC or following UDITPA provisions is neither mandatory nor universal. In fact, even some states that belong to MTC have amended the UDITPA provisions to affect certain companies doing business in their state.

The most common amended formula is a double weighting of the sales factor. The effect of this change is to "export" tax liability to those companies that sell a lot in a particular state but do not have a corresponding investment in plant, equipment, machinery or jobs in that state. To the extent that a particular level of income tax is obtained from all businesses, any exportation of tax liability benefits resident businesses accordingly.

We must point out that apportionment can be extremely complex, confusing and controversial. We recognize the potential benefits of amending the formula, but a specific study must be undertaken using actual data and applying various "what if" scenarios before any decision can be made.

B. The subcommittee recommends that the State study the ramifications of adopting Alternative Minimum Tax provisions that parallel both in form and rate structure the federal Alternative Minimum Tax provisions.

Comment: This recommendation is similar to the earlier one regarding State conformity with federal penalty and appeal provisions. It is primarily a practitioner concern, but can have an impact on certain taxpayers as well. Some members of the subcommittee stated it was unclear whether or not the State even had an alternative minimum tax, based on conflicting advice from Bureau of Taxation personnel. If such confusion exists at the practitioner level, it is imperative that someone clarify the issue as soon as possible. Since this subcommittee was not responsible for this type of very specific review, we do not pretend to address the situation in this report. We note it in an effort to ensure a future review by another study group.

The final recommendations of this subcommittee reflect the same concerns raised in other subcommittees. Property taxes, especially those on personal property (as opposed to "real" property such as land and buildings), make up a large part of the tax burden on Maine business and industry. Since tax policy is at least a part of a company's business location decision making (the subcommittee found the literature on this issue to be diverse), some companies are being hurt by the personal property tax. This is especially true for paper companies and other large manufacturers that operate in different states, any of which would

be capable of handling the increased development investment. Therefore, the subcommittee recommends that the personal property tax for business and industry be phased out over a period of time, provided that municipalities be reimbursed for 100% of any lost revenue.

This proviso is particularly troublesome. We know it is expensive, with an estimated cost of \$85 million, but it is an issue of statewide importance. Phasing out the tax will lessen the short term effect, but exceeding the 50% reimbursement mandated by the Constitution adds significantly to the total cost to the State. Other people argue that without jobs and increased investment by business and industry, which are threatened by the property tax, the cost to the State will be even greater than \$85 million! In an effort to ease the reimbursement problem somewhat, this subcommittee goes beyond subcommittee 2 and further recommends that if the personal property tax is phased out, the investment tax credit also be phased out over the same period of time.

The investment tax credit was recently established to spur new investment in Maine. Although it is an income tax credit, it was created in part to help offset the property tax burden associated with the increased valuation of new machinery and equipment. With an estimated annual loss of State revenue of \$15-\$16 million, elimination of this credit could go hand in hand with elimination of the personal property tax, thereby offsetting some of the revenue needed to reimburse municipalities. New sources of revenue

or growth in existing sources might offset the remaining amount, depending on how quickly the phaseout is implemented.

Finally, a majority of subcommittee 3 recommends the appointment of a highly qualified group to study State spending, with the goal of reducing the overall tax burden in Maine by identifying potential areas where spending can be reduced. This may or may not be the ACIR type of group discussed by subcommittee 2, or it could be similar to the Maine Cost Management Survey undertaken a few years ago. Whatever the format, the subcommittee believes that spending levels drive tax policy, not vice-versa. If spending decreases, our tax structure can be altered to reflect the reduction. If spending increases, our already overburdened tax structure will fail because it will not generate enough revenue to handle such spending, and what revenue is generated, may not be raised in the fairest, simplest or most progressive manner.

