Department of Administrative and Financial Services

Overview of Tax Expenditures and Review of the "Revenue Outlook Forecast- Tax Expenditures" Section of the Governor's Budget Overview

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Outline of Presentation

- Purpose of Tax Expenditure Reports
- Tax Expenditure Related Reports Required by Maine Revised Statutes
- Identifying Tax Expenditures
- Estimating Tax Expenditures
- Income Tax
- Sales Tax
- Maine Tax Incidence Study & OPEGA Tax Expenditure Evaluations

What's the Purpose of a Tax Expenditure Report?

The tax expenditure budget is a concept that was developed to assure a budget review process for tax preferences similar to the review required for direct expenditure programs. The federal government and most state governments engage in a periodic review of tax expenditures. Generally, tax expenditures provide tax incentives designed to encourage certain activities by taxpayers or provide relief to taxpayers in special circumstances. Many tax expenditures are the equivalent of a governmental subsidy in which the foregone tax revenue is essentially a direct budget outlay to specific groups of taxpayers

Title 5: ADMINISTRATIVE PROCEDURES AND SERVICES

Part 4: FINANCE

Chapter 149: BUDGET

§1666. Review and revision of estimates

A budget document transmitted by the Governor or Governor-elect must include a part that asks the Legislature whether it wishes to continue funding each individual tax expenditure provided in the statutes. For purposes of this paragraph, "tax expenditures" means those state tax revenue losses attributable to provisions of Maine tax laws that allow a special exclusion, exemption or deduction or provide a special credit, a preferential rate of tax or a deferral of tax liability. The part must include for each tax expenditure a statutory section reference, a brief description of each tax expenditure and the loss of revenue estimated to be incurred by funding source and fiscal year. The joint standing committee of the Legislature having jurisdiction over appropriations and financial affairs shall consider any reports regarding the evaluation of tax expenditures completed during the previous 2 years pursuant to Title 3, sections 999 and 1000 and shall hold at least one public hearing to receive public comment regarding those tax expenditures when reviewing the continuation of tax expenditures pursuant to this section. This paragraph applies with respect to the preparation of the budget document for the 2008-2009 biennium and thereafter. [PL 2015, c. 344, §5 (AMD).]

Maine Tax Expenditure Reports – MRS (Red Book)

Title 36: TAXATION
Part 1: GENERAL PROVISIONS
Chapter 10: TAX EXPENDITURE REVIEW

§199-B. Report

1. Report. The bureau shall submit a report regarding tax expenditures to the committee by February 15th of each odd-numbered year. The report must contain:

A. A summary of each tax expenditure in the laws administered by the bureau; [PL 2001, c. 652, §7 (NEW).]

B. A description of the purpose and background of the tax expenditure and the groups likely to benefit from the tax expenditure; [PL 2001, c. 652, §7 (NEW).]

C. An estimate of the cost of the tax expenditure for the current biennium; [PL 2001, c. 652, §7 (NEW).]

D. Any issues regarding tax expenditures that need to be considered by the Legislature; [PL 2017, c. 211, Pt. E, §4 (AMD).]

E. Any recommendation regarding the amendment, repeal or replacement of the tax expenditure; and [PL 2017, c. 211, Pt. E, §4 (AMD).]

F. The total amount of reimbursement paid to each person claiming a reimbursement for taxes paid on certain business property under chapter 915.

Identifying Tax Expenditures

- What's the baseline law? – A tax expenditure is an exception to baseline provisions of the tax structure that usually results in a reduction in the amount of tax owed. Therefore, establishing the baseline is an important first step to determining tax expenditures.
- Normal Law – Broad based, theoretical construct
  - Income Tax: a practical variant of a comprehensive income tax that acknowledges certain accepted exceptions (e.g. personal exemption and standard deduction).
  - Sales Tax: base is intended to be household consumption, so tax all household consumption purchases and exempt all business input purchases.
- Reference Law – Existing law, based on normal law but recognizes historic structure of statutory tax law
  - Income Tax: expands on accepted exceptions to normal law (e.g. tax rate schedules based on filing status, exclusion of government transfer payments).
  - Sales Tax: *36 M.S.R.A. § 1811* "all tangible personal property and taxable services sold at retail in this state." "Retail sale" means any sale of tangible personal property or a taxable service in the ordinary course of business.
- The report uses broad definitions of the benchmark income and sales tax bases to maximize the number of tax expenditures identified and thus provide the most information to legislators. The choice of benchmark law does not reflect a judgment that benchmark law is preferred to current law. One area where the choice of normal law is important is when making cross-state comparisons of tax expenditures, as different choices of normal law will lead to different lists of expenditures even when states have identical tax policies.

Identifying Tax Expenditures

- There are a few other important considerations for the definition of normal tax law in this report. The report defines normal law to exclude as a tax expenditure those parts of the law that are (1) established by federal mandate (e.g., the sale tax exclusion for food stamp purchases), (2) created at the state level to maintain conformity with normal tax law when the federal government deviates from that law because it creates credits that the state does not adopt (e.g., the subtraction modification associated with federal work opportunity credit), (3) the result of the state taxing certain activities under a different tax system (e.g., the income of a financial institution that is an S corporation), and (4) Constitutionally prohibited (e.g., credit for taxes paid to other jurisdictions).
- Negative Tax Expenditures – Tax provisions that provide treatment less favorable than normal income tax law. (e.g. disallowance of certain deductions, sales tax rates higher than the general tax rate)
- Includes tax expenditures that are arguably "appropriations" but impact GF revenues (e.g. BETR, BETE, ETIF)

Estimating Tax Expenditures

- In estimating the revenue loss attributed to particular tax expenditure, it is assumed that the provision of law granting special tax treatment is repealed and that no other changes in tax law, taxpayer behavior or general economic activity occur as a result of its repeal. <u>Consequently, it should not be concluded that the repeal of any of these tax expenditures will necessarily generate the amount of revenue which they are estimated to forego</u>. Differences between the tax expenditure estimate and the revenue raised by repeal can be especially large for provisions related to timing, such as depreciation and deferment of income recognition, and for tax credits where carryforwards are a large component of the credit. In these cases, and especially in the near term, the revenue gain from ending a tax expenditure may be significantly different from the revenue cost of maintaining the expenditure.
- Some tax expenditures are estimated rather accurately from available administrative information or the state's micro-simulation tax models. For a much larger number of expenditures, special data must be developed which is less complete and accurate. Estimates for fiscal year 2022 and fiscal year 2023 generally assume modest increases in household and business activity as the economy recovers from the COVID-19 recession, based on the economic forecast provided by the Consensus Economic Forecasting Committee in November 2020.
- Finally, there are some expenditures where little concrete information exists, and our limited resources prevent any special survey or other data generation procedures. Estimates for this group are reported as a range.

Income Tax

- For the income tax OTP reports adopt the same definition of normal income tax law as the Congressional Joint Committee on Taxation uses to identify federal income tax expenditures. The normal law tax structure includes personal exemptions, the standard deduction, the current tax rate schedule, and business expenses deductions. The base for normal law is much broader than taxable income. Tax expenditures are exclusions, exemptions, or deductions that reduce taxable income below the "normal law" tax base and also tax credits, preferential tax rates, or income tax deferral that reduce income tax liability.
- Maine conforms to the IRC through Federal Adjusted Gross Income (FAGI - Individual) and Federal Taxable Income (FTI – Corporate). Maine specific tax expenditures that deviate from FAGI and FTI are included, as well as federal tax expenditures that we conform to.

Income Tax

- State Subtraction Modifications
  - Deduction of Social Security Benefits Taxable at Federal Level
  - Deduction for Pension Income (Full Exemption for Military Pensions)
- State Tax Credits
  - Credit for Educational Opportunity
  - Pine Tree Development Zone Credit
  - Property and Sales Tax Fairness Credits
- Federal Conformity – Above the line deductions
  - Deduction for interest of student loans
  - Teacher Expense Deduction
  - Pension Contributions (IRS, SEP, Simple, & Keogh Plans)
- Federal Conformity with FAGI
  - Employer-Paid Medical Insurance and Expenses
  - Exclusion of Capital Gains on Sales of Principal Residences

Sales & Use Tax

- Defining normal sales tax law is complicated because there are competing theoretical constructs for what this benchmark should be. One possibility is that the normal sales tax base is defined by *36 M.S.R.A. § 1811* and includes "all tangible personal property and taxable services sold at retail in this state." Under this definition, sales tax exclusions for services are _not_ tax expenditures but sales tax exemptions for business purchases of tangible personal property *are* tax expenditures. Another possibility is that the normal sales tax base is all retail purchases for consumption. In this case, sales tax exclusions for services _are_ tax expenditures but sales tax exemptions for business purchases of tangible personal property are _not_ tax expenditures because these purchases are not consumption. This report defines the normal sales tax base as the combination of these two bases. Thus the benchmark base includes all sales of tangible personal property and services sold at retail, and both exemptions for business purchases and exclusions for the purchase of services are counted as tax expenditures.

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Maine Sales & Use Tax Law
Title 36, Section 1811

"A tax is imposed on the value of all tangible personal property, products transferred electronically and taxable services sold at retail in this State."

- Tax applies to anything that can be seen, felt and touched
- Applies to digital products if nondigital physical form is subject to tax. Must be sale of digital product that is downloadable.
- Sales of services are generally excluded, unless specifically subject to sales tax (e.g. rental of living quarters, rental or lease of automobile, transmission and distribution of electricity, etc.). Other services (e.g. telecommunications, cable and satellite, fabrication services) are subject to the Service Provider Tax.
- Retail sale means (Section 1752.11) "any sale of tangible property or taxable service in the ordinary course of business." Some sales tax exclusions (currently 17) are applied through an exclusion from the definition of retail sale (e.g. casual sale, businesses subject to the Service Provider Tax, sales to a retailer for resale).

Section 1760 Sales Tax Exemptions (106)

- Exemptions can be grouped into the following categories
  - Exemption Goods (e.g. grocery staples, prescription drugs, packaging materials)
  - Exempt Services (e.g. living quarters at summer camps, education, work related)
  - Nonprofit Organizations – A nonprofit is defined as an organization granted federal tax exemption under 501(c). **Maine does not provide a blanket sales and use tax exemption for nonprofit organizations.** Mostly purchases by, rather than sales by the nonprofit.
  - Certain Establishments (e.g. schools, houses of worship, credit unions, political subdivisions)
  - Casual Sales – "an isolated transaction in which tangible personal property or a taxable service is sold other than in the ordinary course of repeated and successive transactions of like character by the person making the sale."

Sales & Use Tax (Business Purchases & Services)

- Business Purchases of Good
  - Manufacturing Machinery and Equipment (1760.31) $50M
  - Fuel and Electricity Used in Manufacturing (1760.9D) $15M
  - Packaging Materials (1760.12A) $30M

- Exclusion of Services – Consumer Purchases
  - Amusement and Recreational Services (1752.11) $65M
  - Transportation Services (1752.11) $65M
  - Personal, Household and Business Services (1752.11) $75M

- Exclusion of Services – Business Purchases
  - Financial Services (1752.11) $270M
  - Legal, Business, Administrative & Support Services (1752.11) $500M
  - Construction Services for Maintenance & Repair (1752.11) $45M

Maine Tax Expenditure Reports – OPEGA Evaluation Reports

Title 3: LEGISLATURE

Chapter 37: LEGISLATIVE OVERSIGHT OF GOVERNMENT AGENCIES AND PROGRAMS

§999. Full evaluation of tax expenditures

1. Evaluation process. Beginning January 1, 2016, the office shall evaluate each tax expenditure identified under section 998, subsection 1, paragraph A in accordance with the schedule established in section 998, subsection 2.

A. Prior to the beginning of each evaluation, the committee, after consideration of recommendations from the office, shall approve the following for each tax expenditure subject to full evaluation: (1) The purposes, intent or goals of the tax expenditure, as informed by original legislative intent as well as subsequent legislative and policy developments and changes in the state economy and fiscal condition;

(2) The intended beneficiaries of the tax expenditure;

(3) The evaluation objectives, which may include an assessment of: (a) The fiscal impact of the tax expenditure, including past and estimated future impacts;

(b) The extent to which the design of the tax expenditure is effective in accomplishing the tax expenditure's purposes, intent or goals and consistent with best practices;

(c) The extent to which the tax expenditure is achieving its purposes, intent or goals, taking into consideration the economic context, market conditions and indirect benefits;

(d) The extent to which those actually benefiting from the tax expenditure are the intended beneficiaries;

(e) The extent to which it is likely that the desired behavior might have occurred without the tax expenditure, taking into consideration similar tax expenditures offered by other states;

(f) The extent to which the State's administration of the tax expenditure, including enforcement efforts, is efficient and effective;

(g) The extent to which there are other state or federal tax expenditures, direct expenditures or other programs that have similar purposes, intent or goals as the tax expenditure, and the extent to which such similar initiatives are coordinated, complementary or duplicative;

(h) The extent to which the tax expenditure is a cost-effective use of resources compared to other options for using the same resources or addressing the same purposes, intent or goals; and

(i) Any opportunities to improve the effectiveness of the tax expenditure in meeting its purposes, intent or goals; and

(4) The performance measures appropriate for analyzing the evaluation objectives. Performance measures must be clear and relevant to the specific tax expenditure and the approved evaluation objectives.

B. Before final approval pursuant to paragraph A, the committee shall seek and consider input from the policy committee and stakeholders and may seek input from experts.

2. Action by office; report. The office shall submit a report on the results of each evaluation to the committee and the policy committee. The office shall seek stakeholder input as part of the report. For each tax expenditure evaluated, the report must include conclusions regarding the extent to which the tax expenditure is meeting its purposes, intent or goals and may include recommendations for continuation or repeal of the tax expenditure or modification of the tax expenditure to improve its performance.