STATE OF MAINE
112TH LEGISLATURE
SECOND REGULAR SESSION

REPORT OF JOINT STANDING COMMITTEE ON TAXATION RELATING TO THE RAILROAD EXCISE TAX

JANUARY 1986

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SUMMARY

This study is conducted by the Joint Standing Committee on Taxation pursuant to Public Law 1985, chapter 477. That law required the Committee to "study the railroad excise tax, including the treatment of long-term freight car leases" and to submit a report to the Second Regular Session of the Legislature "containing recommendations for any neccessary changes in the tax, including permanent retention of the treatment of long-term freight car leases."

The raiload excise tax is a tax imposed for the privilege of operating a railroad in the State of Maine. It is currently a tax upon gross receipts which varies according to the relationship of net railway operating income to gross transportation receipts. It allows for a 5 3/4% rate of return on investment provided that allowance does not reduce the tax below 1/4 of 1% of gross transportation receipts. The tax has, since 1979, contained a provision which permits railroads to include within operating investment (the base for calculation of allowable rate of return) the value of freight car operating leases of 10 years or more.

The Joint Standing Committee on Taxation has reviewed the railroad excise tax. It has received information from staff, the Attorney General's office, the Bureau of Taxation and representitives of railroads. It has investigated the impact

of eliminating the long term operating lease provision both upon State revenues and on railroads.

The Committee makes the following recommendations:

Recommendation #1: Continue the long term operating lease provision for one more year and await recommendations of the Special Legislative Committee to Study State Assistance to the Rail Industry.

Recommendation #2. Permit the long term operating lease provision to expire this year and maintain the same total tax collection by reducing each of the rates of the sliding scale basic tax by 1/4 of 1%.

Recommendation #3: Same as recommendation #2 but also restrict the consideration of gross transportation receipts to those attributable to the United States.

BACKGROUND

Maine's railroad excise tax was originally enacted in 1871. Other than changes in the rate of the tax, there has not been much change in the structure of the tax since that time. The excise tax enacted in 1871 contained a sliding scale rate that varied according to the gross receipts per mile of the railroad. The rate varied from 1/4 of 1% to 4% of gross receipts. The tax was in lieu of other taxes except for the tax on land and buildings located in the right of way. In these early years all of the major railroads were taxed at the maximum rate.

The next major change in the tax came in the 1920's when the basis of the tax was changed. This change came in response to railroad complaints about the growth of government subsidy of highway transportation. The old formula based upon gross receipts per mile was changed to a formula which was intended to take into account profitability. The new formula, which remains essentialy unchanged, varied according to the relationship between gross receipts and net railway operating income. The rate of the tax varied from 3 1/2% to 5 1/2% which was later reduced to 3 1/4% to 5 1/4% of gross receipts.

In 1961, with the fortunes of the railroads in serious decline, a new factor was added to the formula which permitted the taxpayer to reduce the tax by an amount which was intended to permit a 5 3/4% rate of return with a minimum tax of 2% of gross receipts. The minimum tax was phased down to 1% of gross receipts in 1971, 9/10 of 1% in 1972 and 1/4 of 1% in subsequent years.

The total amount collected from the railroad excise tax has apparently remained quite stabile throughout much of this century with some declines in recent years. In 1921, the State collected over $1,900,000 from the railroad excise tax. In the 1950's, the total tax collections fluctuated around $1,200,000 to $1,500,000. In 1985, the total amount collected for tax year 1984 was $1,291,468; 1982 was a bad year with total collections at $604,795..

In the mid 1970's, there was a flurry of activity on behalf of the railroads to further reduce the burden of the railroad excise tax. In 1975, legislation was passed by both the House of Representatives and the Senate which would have permitted railroads to exclude from gross transportation receipts certain revenues which had been restricted in use by the Interstate Commerce Commission. The bill was vetoed by the Governor; however, and his veto was sustained. That same year an interim committee was created by the Legislature to study the railroad excise tax. That Committee recommended the elimination of the minimum tax. This recommendation would result in railroads paying no tax in years when they did not achieve the allowed rate of return on investment. That recommendation died between houses. In 1979, a bill was introduced to increase the allowable rate of return to 12%. This bill was amended in Committee to provide the current language relating to the special treatment of long term freight car operating leases with a two year sunset provision. The long term freight car operating lease provision has been extended for periods of one to two years since 1979.

THE CURRENT TAX

The railroad excise tax is a tax upon gross transportation receipts. The rate of the tax depends upon the relationship of net railway operating income (essentially profit) to gross transportation receipts. A sliding scale is specified which results in the following basic rates:

Rate of tax	If NROI-GTR
3 1/4%	is not greater than 10%
3 3/4%	is greater than 10% but not greater than 15%
4 1/4%	is greater than 15% but not greater than 20%
4 3/4%	is greater than 20% but not greater than 25%
5 1/4%	is greater than 25%

The base tax may then be reduced by the amount by which 5 3/4% of operating investment exceeds net railway operating income. This essentially permits a 5 3/4% rate of return. However, a minimum tax of 1/4 of 1% must be paid. Currently, most railroads in Maine are paying the minimum tax.

Currently railroad companies may either own there freight cars or lease them from another entity. If the railroad chooses to lease freight cars, there are basically two different types of leases that may be used. Capital leases are leases which, by their terms are very similar to time purchase agreements. In accounting practices and tax procedure, these leases are generally treated as if the railroad owned the freight car. The cars are treated as capital assets and are depreciated over their specified useful life. Operating leases are usually shorter term leases where the owner retains the ability to depreciate the freight car and the company leasing the car includes the cost of the lease in its annual operating expenses.

Under the Maine railroad excise tax, freight car operating leases of 10 or more years are expenses of the railroad company which are used to reduce the tax paid through the calculation of net railway operating income. Under the provisions enacted in 1979, those leases are also considered to be part of the capital base for purposes of calculating the rate of return reduction from the basic tax. The result is that these leases are used in two different ways to reduce the amount of tax that the railroad must pay. This treatment is generally considered to be inconsistent with normal accounting procedures.

GOVERNOR'S ADVISORY COMMITTEE

In June of 1984, Governor Joseph Brennan by executive order established the Governor's Advisory Committee for the Development of a Rail Transportation Policy for the State of Maine. The Advisory Committee was directed to consider the needs of rail transportation users, the implications of potential abandonment of existing rail lines and the potential for State involvement. The Advisory Committee was composed of representatives of the Legislature, municipal organizations, the railroad industry, labor and rail transportation users.

The Advisory Committee recommended that the State assume 50% of the cost of maintaining rail-highway bridge and grade crossings and that the State approve a bond issue for the acquision of certain abandoned rail lines and subsequently maintain them. Each of these provisions was enacted into law contingent upon approval of the bond issue by the voters. The bond issue was approved, making those provisions effective.

In addition, the Advisory Committee recommended enactment of two tax provisions to provide a benefit to railroads operating in Maine. The first of these was a sales tax exemption for rail track materials. The second was permanent retention of the long term operating lease provision in the railroad excise tax. This bill was identical to LD 357, AN ACT Concerning the Rate of Return on Investment Factor Under the Railroad Excise Tax which had been submitted earlier in the session by Representative Peter Manning of Portland. The sales tax exemption, with an estimated annual cost of $180,000 was enacted. The excise tax provision, with an estimated cost of $300,000, was extended for one additional year.

As a result of Legislative consideration of these bills, two studies were authorized to look at various aspects of the State's rail policy. This Committee was authorized to study the tax issues and another study was approved made up of two representatives each from the Joint Standing Committees on Appropriation, Taxation and Transportation. That Committee was required to review State policy toward railroads in light of the recent legislative action.

PROCEDURE:

The Taxation Committee met to discuss this study five times during the autumn of 1985. It received information from staff, the Attorney General's office, the Bureau of Taxation and several railroads. One railroad, in particular, Maine Central Railroad, advocated for retention of the long term operating lease provision. Maine Central also advocated for an increase in the rate of return factor from 5 3/4% to 12% or a figure which would be based upon the prime interest rate.

Another railroad, Canadian Pacific, expressed concern that the railroad excise tax formula treated that railroad unfairly because it resulted in Canadian Pacific paying a share of the total tax which was disproportionate to the number of miles of track located in the State of Maine compare to other railroads in the State. Canadian Pacific also objected to the tax because it resulted in a tax which was based upon the overall profitability of the railroad. Canadian Pacific maintained that the tax ought to based soley upon gross receipts attributable to Maine operations. Canadian Pacific had, during the Regular Session of the Legislature, made this same argument. At that time a cap on the total amount of tax was advocated, and the majority report of the Taxation Committee on LD 357 contained such a cap. The cap was dropped on the Appropriations Table, however, because of the estimated cost. At that time Canadian Pacific was projecting dramatic increases in the amount of tax which it would be obligated to pay over the next several years. New projections presented to the Committee by Canadian Pacific this fall indicated that its tax picture was now expected to be very different. In fact, the railroad estimated that it would be paying the minimum tax over the next few years. Instead of a cap on the amount of tax, Canadian Pacific was now advocating for a change in the formula for calculation of the tax. Apportionment based upon revenue/ton/miles was recommended. Canadian Pacific also presented the argument that if the excise tax was in lieu of certain property taxes, that it ought to more closely approximate what a property tax would collect.

The Committee recognized that the railroad excise tax formula results in a volatile tax. If a railroad has a comparatively bad year, the rate of return deduction, reducing the tax to the minimum of 1/4 of 1% can result in a dramatic reduction in the amount of tax owed.

RECOMMENDATIONS:

The Committee divided three ways regarding recommendations as a result of this study. The three variations are listed below.

RECOMMENDATION #1: CONTINUE THE LONG TERM OPERATING LEASE PROVISION FOR ONE MORE YEAR AND AWAIT RECOMMENDATIONS OF THE SPECIAL LEGISLATIVE COMMITTEE TO STUDY STATE ASSISTANCE TO THE RAIL INDUSTRY.

The Special Legislative Committee to Study State Assistance to the Rail Industry, composed of two representatives of the Joint Standing Committees on Appropriations, Taxation and Transportation was appointed to "study the feasibility of state assistance to the rail industry in response to existing and developing rail transportation problems." That Committee, composed of members of the three Committees with an interest in rail assistance issues, should provide a comprehensive context for the resolution of all remaining issues relating to railroads. Until that Committee makes its recommendations, the staus quo with regard to railroad taxation should be maintained and the long term operating lease provision should be extended for one more year.

This recommendation has the support of Senators Twitchell and Emerson and Representatives Jackson, Ingraham and Webster.

<u>RECOMMENDATION #2: PERMIT THE LONG TERM OPERATING LEASE PROVISION TO EXPIRE THIS YEAR AND MAINTAIN THE SAME TOTAL TAX COLLECTION BY REDUCING EACH OF THE RATES OF THE SLIDING SCALE BASIC TAX BY 1/4 OF 1%.</u>

The long term operating lease provision ought to be eliminated because it does not make sense to treat long term leases both as items to be expensed and to be included within capital for purposes of calculating a rate of return. This practice does not agree with normal accounting or tax practices. It would make more sense to provide the same total benefit to railroads by reducing the basic sliding scale rates to result in the same total amount of excise tax collected from railroads.

This action is also fairer because it assists all railroads equally. The long term operatin lease provision was enacted primarily for the benefit of one railroad, and it is one railroad which continues to take primary advantage of the provision.

There is nothing to be gained from extending the long term lease provision for another year. The Special Committee to Study State Assistance to the Rail Industry has decided at its first meeting to defer consideration of the issues relating to the taxation of railroads to the Taxation Committee. Unless they change that decision, they will not be making any recommendations relating to taxation.

It should not be necessary to make any adjustment for Canadian Pacific. An excise tax is imposed for the privilege of engaging in a particular. The value of that privilege has little to do with the value of property that a railroad owns. The excise tax was never intended to be a monetary value replacement for the property tax. When a railroad has lines both inside and outside of Maine, a method must be chosen for apportioning gross receipts. It should make no difference whether the other portions of the lines are in Canada or another state. The current formula provides a fair and equitable calculation of the tax.

This recommendation has the support of Representatives Cashman and Mayo.

<u>RECOMMENDATION #3: SAME AS RECOMMENDATION #2 BUT ALSO RESTRICT THE CONSIDERATION OF GROSS TRANSPORTATION RECEIPTS TO THOSE ATTRIBUTABLE TO THE UNITED STATES.</u>

It is not appropriate for the State of Maine to be taxing foreign earnings. The unitary provision of the state income tax provides that income attributable to a foreign subsidiary should not be taxed in Maine unless it is also subject to a federal income tax. The railroad excise tax is similar to an income tax and ought to be subject to the same restriction.

The current tax formula unfairly takes into consideration earnings of the Canadian Pacific Railroad that have no relation to its operations in Maine. The result is that in recent years, Canadian Pacific has paid a share of the total tax which is disproportionate to the comparative number of miles of track that it operates in Maine..

This recommendation has the support of Representative McCollister.