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TAX EXPENDITURE REVIEW

FINAL REPORT

Maine Capital Investment Credit (MCIC) – A Complicated Response to Federal Bonus Depreciation that Is Unlikely to Significantly Encourage Capital Investment in Maine

Report No. TE-MCIC-17

a report to the
Government Oversight Committee and Taxation Committee
from the
Office of Program Evaluation & Government Accountability
of the Maine State Legislature

February
2020

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DANIELLE D. FOX
DIRECTOR

MAINE STATE LEGISLATURE

OFFICE OF PROGRAM EVALUATION AND
GOVERNMENT ACCOUNTABILITY

February 21, 2020

Sen. Justin M. Chenette, Chair
Rep. Anne-Marie Mastraccio, Chair
Members Government Oversight Committee

As directed by the 128th Legislature's Government Oversight Committee (GOC), and in accordance with the parameters approved by the Committee, OPEGA has completed a review of the Maine Capital Investment Credit (MCIC). The approved project parameters, included in Appendix E, establish the goals, intended beneficiaries, and base performance measures considered in this evaluation. The scope and methods for this review can be found in Appendix A.

OPEGA conducts reviews of tax expenditures in accordance with Title 3 §§998 and 999. The statutory tax expenditure review process ensures that tax expenditures are reviewed regularly, according to a schedule approved by the GOC. The process is detailed in Appendix D.

OPEGA would like to thank the management and staff of MRS for their cooperation throughout this review.

In accordance with Title 3 §997, OPEGA provided MRS an opportunity to submit comments after reviewing the report draft.

Sincerely,

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Director, OPEGA

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Table of Contents

What is the Maine Capital Investment Credit? **1**
About the Maine Capital Investment Credit and OPEGA's evaluation 1
Depreciation affects the amount of income tax a business owes 2
Federal bonus depreciation allows taxpayers to reduce taxable income now, rather than later 2
Maine does not conform to federal bonus depreciation 3
Maine's current method for decoupling from bonus depreciation involves modifications to taxable income over multiple years 4
MCIC is an optional credit calculated based on Maine's bonus depreciation add-back 5
Recent changes made MCIC more equitable for taxpayers 6

Is MCIC likely to encourage businesses to expedite capital investment? **7**
Historically, many eligible taxpayers have not claimed bonus depreciation 7
When claimed, bonus depreciation has not been found to have a significant impact on capital investment 8
Even if it doesn't encourage investment, some studies have found bonus depreciation may impact businesses in other ways 9

Is MCIC an effective way to encourage businesses to choose Maine over other locations when making capital investments? **9**
Conforming to bonus depreciation provides two benefits for businesses 9
Most states, like Maine, decouple from bonus depreciation, and some try to make decoupling easier on businesses 10
Maine's uniquely complex approach to providing some of the financial value of conformity seems unlikely to confer a competitive advantage 10

Findings **12**

Appendices
Appendix A. Scope and Methods 14
Appendix B. Changes to Statutory Authorization for MCIC Since Enactment 16
Appendix C. Analysis of the Impact of Changes in PL 2019, c. 527 17
Appendix D. Maine's Tax Expenditure Review Process 19
Appendix E. GOC Approved Evaluation Parameters 20

Acronyms Used in This Report

CRS – Congressional Research Service
DAFS – Department of Administrative and Financial Services
GOC – Government Oversight Committee
IRC – Internal Revenue Code
IRS – Internal Revenue Service
MCIC – Maine Capital Investment Credit
MRS – Maine Revenue Services
OPEGA – Office of Program Evaluation and Government Accountability

Terms Used in this Report

Add-back (Addition Modification). At present, if a taxpayer claims federal bonus depreciation, Maine requires that the difference between federal depreciation, and depreciation that would have been allowed in the first year if bonus depreciation did not exist, be added back to their taxable income for the purposes of calculating Maine income taxes.

Apportionment factor. A business's Maine sales as a % of its total U.S. sales.

Conformity. Conformity refers to the concept that a state may choose whether to follow provisions of the Internal Revenue Code (IRC) for state income tax computations. A state is considered "conforming" for IRC provisions that it opts to follow and is considered "decoupled" for IRC provisions it opts not to follow. A state's conformity decisions may be revisited and changed over time.

Depreciation. For tax purposes, depreciation is an expense that reduces a business's taxable income. This expense recognizes the loss of value for an asset over the asset's useful life. According to the IRS:

> Depreciation is an annual income tax deduction that allows you to recover the cost or other basis of certain property over the time you use the property. It is an allowance for the wear and tear, deterioration, or obsolescence of the property (IRS Publication 946, pg.3).

In a given year, a depreciation deduction reduces the amount of taxes paid. Over time the sum of the deductions should equal the cost of the investment.

Internal Revenue Code (IRC). Legislation governing federal tax law.

Maine-only businesses. Refers in the report to companies that have 100% apportionment.

Multi-state businesses. Refers in the report to companies that have less than 100% apportionment.

Subtraction modification. At present, Maine allows modifications to a taxpayer's taxable income, in the years after bonus depreciation was claimed, to recognize the depreciation that would have been claimed absent bonus depreciation. This modification is allowed each year for the depreciable life of the asset. The total amount of the subtraction claimed for all tax years may not exceed the addition modification for the same property.

Taxable income. For this report, the amount of income on which income taxes are assessed.

Maine Capital Investment Credit – A Complicated Response to Federal Bonus Depreciation that is Unlikely to Significantly Encourage Capital Investment in Maine

What is the Maine Capital Investment Credit?

MCIC is a complex approach to bonus depreciation, and some versions have provided unequal benefits to in-state and multi-state businesses.

About the Maine Capital Investment Credit and OPEGA's evaluation

The Maine Capital Investment Credit (MCIC) is a personal and corporate income tax credit for depreciable property, such as equipment and buildings, placed in service in Maine. The credit is available to Maine taxpayers who claimed bonus depreciation on their federal income tax returns under section 168(k) of the Internal Revenue Code (IRC). It is non-refundable and may be carried forward for up to 20 years.

MCIC was enacted in 2011 and is administered by Maine Revenue Services (MRS). The credit has been changed a number of times since its enactment. All of its iterations have been tied directly to federal bonus depreciation. The most recent form of the credit is authorized under Title 36 §5219-NN(1-A)[1]. For the purposes of describing MCIC, this section of the report, except where otherwise specified, focuses on the most recent form of the credit. However, conclusions and major findings discussed in all other sections apply to MCIC generally, rather than to any specific iteration of the program.

Review of the legislative record shows that MCIC has evolved as Maine's response to federal bonus depreciation. This suggests the program's goal may be aligned with the outcomes generally associated with conformity with the federal IRC. However, in 2017 when the Government Oversight Committee established the evaluation parameters for MCIC, they determined the goals should be centered on encouraging businesses to expedite capital investments in Maine. Pursuant to statute, the Committee's determination of these parameters was made in consultation with the Taxation Committee and considered input from stakeholders. For the purposes of this evaluation, OPEGA considered the program from both perspectives – as an approach to bonus depreciation conformity, and as a policy tool to encourage capital investment in Maine.

A note to the reader: The remainder of this section of the report provides a basic description of the MCIC program and of underlying tax concepts such as conformity and depreciation. We acknowledge that, in providing a high level overview of these topics, we may have sacrificed some degree of nuance and technical precision. For those interested in all of the technical details, we refer you to the MRS guidance document "Modifications Related to Bonus Depreciation & Section 179 Expensing" and the other sources cited in Appendix A of this report.

[1] For tax year 2020, MCIC is governed by Title 36 §5219-NN(1-A). However, other tax years were governed by other sections of Title 36. See a table of all sections in Appendix B.

Depreciation affects the amount of income tax a business owes

Taxable Income — the amount of income on which income taxes are assessed

Generally speaking, the basis for a business's taxable income is the amount of income earned less expenses and other deductions. Taxable income is the amount of income on which the business must pay taxes.

Total Income – Expenses & Other Deductions = Taxable Income

Taxable Income x Tax Rate = Income Taxes Owed

Depreciation — the process of deducting, over time, the expense of investments in assets

Depreciation is a deduction allowed in the federal tax code. In basic terms, it is the process of deducting from a business's taxable income, over time, the expense of investment in an asset. Consider, for example, a business that purchases a $600,000 machine that is expected to last three years. Depreciation divides the purchase cost of $600,000 over the 3-year life of the asset. Under the simplest depreciation method – the straight-line method – this machine would be depreciated by $200,000 per year for three years.[2] When this depreciation is applied to the business's income taxes, the business's taxable income is reduced by $200,000 per year.

Federal bonus depreciation allows taxpayers to reduce taxable income now, rather than later

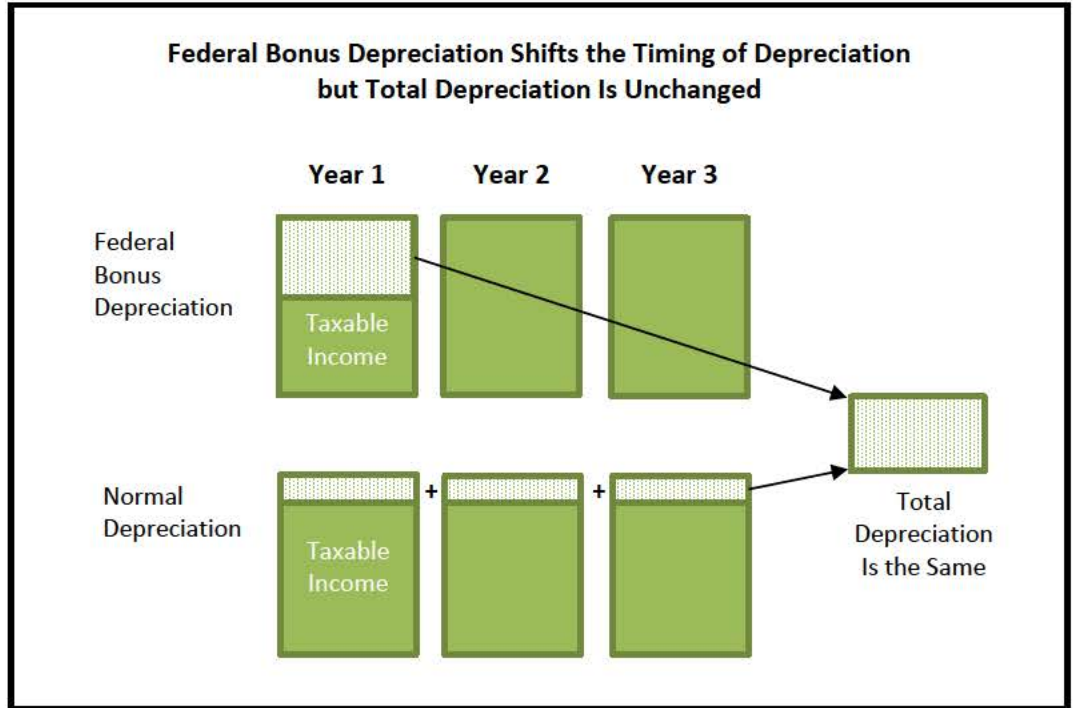
Bonus depreciation is authorized under section 168(k) of the IRC and was created in the Job Creation and Worker Assistance Act of 2002 for the short-term purpose of providing economic stimulus during an economic slowdown. However, bonus depreciation has been extended multiple times since its enactment, resulting in nearly continuous availability for more than 15 years – although at varying bonus rates. This has led some at the federal level to suggest it may be effectively becoming a permanent part of the tax code.[3]

The "bonus" in federal bonus depreciation is the option to deduct more depreciation in the first year than would otherwise be allowed. This reduces taxable income in that tax year, and therefore reduces taxes owed in that year. The current iteration of bonus depreciation allows 100% of depreciation to be taken in the first year. Historically, the bonus depreciation rate has varied, and with it, the value of the benefit has shifted.[4] Bonus depreciation applies to a wide range of depreciable property from fruit-bearing trees to office equipment to machinery and barges.

Using the earlier example of the business that purchased the $600,000 machine, under normal depreciation the business would have reduced its taxable income by $200,000 per year for three years.[5] If instead, the business opted to claim bonus depreciation, it would reduce its taxable income by $600,000 – the full cost of the

[2] OPEGA uses straight-line depreciation for this example because it is the simplest method of depreciation; however, it may not be the most commonly used.
[3] Gravelle, Jane G. 2014. "Bonus Depreciation: Economic and Budgetary Issues." *Congressional Research Services Report*: 1.
[4] Beginning with its enactment in 2002, bonus depreciation allowed just 30% of an asset's value to be deducted in the first year. It allowed 50% for much of 2012 through 2017.
[5] The phrase "normal depreciation" is used in this report to refer to the depreciation that a business would otherwise have claimed on an asset, absent federal bonus depreciation.

asset – in the first year. This would leave no depreciation to reduce taxable income in years two or three.



As illustrated above, bonus depreciation reduces taxable income in the first year. However, in subsequent years, taxable income will be higher than it would have been if depreciation had been spread across the asset's life.[6] The business deducts the same total depreciation over the life of the asset, but bonus depreciation allows the taxpayer to change the timing of that depreciation in order to realize the tax benefits of depreciation sooner, rather than later.

Maine does not conform to federal bonus depreciation

Conforming – when state tax policy follows the Internal Revenue Code

Decoupling – when state tax policy diverges from the Internal Revenue Code

Maine uses a business's federal taxable income as a starting point in determining a business's state taxable income. A business's federal taxable income factors in a number of deductions that reduce the amount of income on which taxes are owed. One of the deductions captured in federal taxable income is depreciation, including bonus depreciation if the business has opted to claim it.

However, the fact that Maine income taxes are based primarily on federal taxable income does not mean that all deductions allowed in the calculation of federal taxable income must be allowed as part of Maine calculation of taxable income. Maine lawmakers decide whether the state will conform with all federal income tax provisions or "decouple" from some, excluding them from the calculation of state income taxes. Businesses generally favor conformity, because alignment between federal and state income tax provisions simplifies the tax filing process. When Maine decouples from a provision that is already factored into a business's taxable

[6] This discussion of taxable income over time isolates the effect of bonus depreciation. However, a taxpayer's taxable income is also affected by many other factors and subsequently may not actually be higher in years after bonus depreciation depending on these other factors. For example, an increase in taxable income may be offset by lower than expected sales that reduce taxable income.

income, a modification is required on Maine income tax forms to undo that federal provision.

Federal Taxable Income + Maine Modifications = Maine Taxable Income[7]

Such is the case here – Maine decouples from federal bonus depreciation, triggering modifications on Maine income tax forms for taxpayers who claimed the bonus at the federal level. However, instead of simply decoupling from bonus depreciation, Maine has attempted to provide taxpayers with the approximate value of conforming to bonus depreciation, but not for all bonus depreciated assets – only for assets located in Maine. The value is approximated via the combination of the MCIC credit and bonus depreciation modifications to Maine taxable income. The impacts of this approach to bonus depreciation are discussed in the following section.

Maine's current method for decoupling from bonus depreciation involves modifications to taxable income over multiple years

Add-back — removes the effect of federal bonus depreciation from Maine taxable income for the year in which federal bonus depreciation was claimed

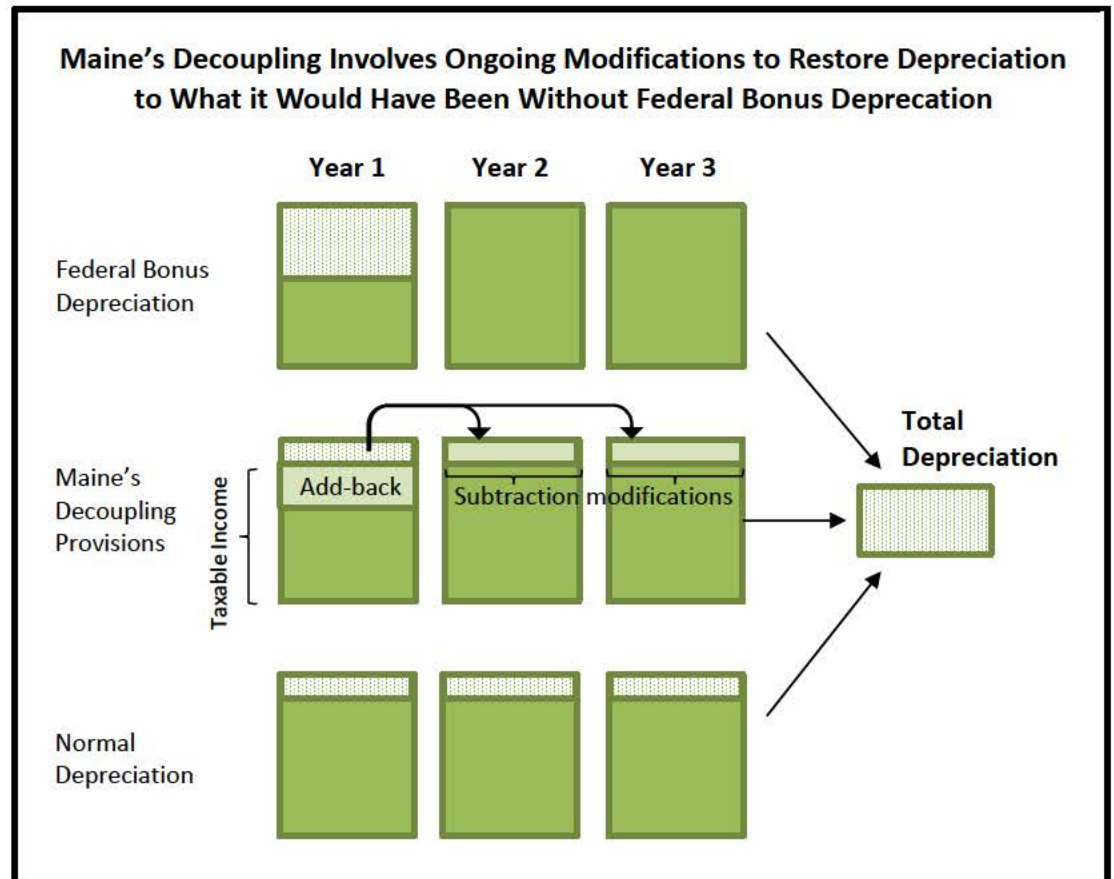
Because Maine decouples from federal bonus depreciation, the Legislature must determine the modifications required to remove the effects of the federal provision. These modifications take away bonus depreciation in the first year and redistribute depreciation over the asset's useful life. At present, this happens via an "add-back" to the amount of taxable income in the first year and subtraction modifications in subsequent years[8].

In the first year of claiming an asset, taxpayers must add back an amount to their taxable income. That amount is the difference between the bonus depreciation claimed at the federal level and the depreciation that would otherwise have been allowed (called the "first year add-back"). This increases the income subject to Maine tax in year one. In subsequent years, subtraction modifications are allowed to recognize the amount that would otherwise have been claimed. The subtraction modification reduces taxable income for subsequent years.

Using the example of the $600,000 machine purchase from earlier in the report, we can see how these modifications affect taxable income. Bonus depreciation allowed the business to claim the full $600,000 cost of the machine as year one depreciation. Under normal (straight-line) depreciation, we established that the machine's year one depreciation would have been just $200,000. The difference between bonus and normal – a difference of $400,000 – is the first year add-back to in this example.

Federal Bonus Depreciation – Normal Depreciation = The Add-back

[7] Other factors may also affect taxable income. However, we are focusing on the effect of bonus depreciation modifications here.
[8] 36 MRSA §5122(1)(KK), §5122(2)(RR), §5200-A(1)(CC) and §5200-A(2)(FF).



In the remaining two years of the $600,000 machine's life, no depreciation could be claimed on federal income taxes because all of the depreciation was used up in the first year. The result is higher federal taxable income. However, Maine's subtraction modifications reduce State taxable income by the amount of depreciation that would normally have been claimed in each year absent bonus depreciation. In this example, those subtraction modifications would be $200,000 per year for the remaining two years of the asset's life.

As a result of the modifications associated with Maine's decoupling from bonus depreciation, businesses claiming bonus depreciation need to keep two sets of records: one to track federal depreciation and a separate one to track state depreciation. This affects bookkeeping for each asset for which bonus depreciation was claimed, including assets eligible for MCIC.

MCIC is an optional credit calculated based on Maine's bonus depreciation add-back

Taxpayers apply the modifications described above for all assets for which they claimed federal bonus depreciation. If they choose to, they may also elect to claim the MCIC credit, but not for all bonus depreciated assets, only for eligible property located in Maine. The MCIC credit amount is the MCIC rate multiplied by the amount of the add-back modification connected with the eligible property. The MCIC rate has varied over time, and was set at 1.2% in the most recent program revision.

$$\text{MCIC credit} = \left[\ 1.2\%\ \right] \times \left[\begin{array}{c}\text{bonus depreciation add-back}\\ \text{for Maine equipment}\end{array}\right]$$

From review of legislative testimony, it appears that the MCIC credit has been designed to work with bonus depreciation modifications to approximate the value that a taxpayer would have received if Maine had conformed to bonus depreciation – but only for assets located in Maine. For multi-state businesses, the limitation of MCIC to assets located in Maine adds another layer of complexity as it necessitates tracking the location of assets for which bonus depreciation was claimed.

Recent changes made MCIC more equitable for taxpayers

PL 2019, c. 527, enacted in the summer of 2019, made the tax impacts of MCIC more equitable between Maine-only and multi-state businesses. These changes apply to bonus depreciation claims beginning with tax year 2020. This statutory change addressed a provision that previously allowed multi-state businesses to derive greater benefit from MCIC than Maine-only businesses due to apportionment rules. The effect of apportionment on the prior version of MCIC is illustrated in Appendix C.

Improving equity for MCIC recipients came at the cost of adding complexity to an already complex program. Prior to chapter 527, MCIC made Maine's decoupling from bonus depreciation somewhat less onerous for businesses by eliminating future year subtractions. These subtractions applied to other bonus depreciated assets, but not to assets claimed under MCIC. Chapter 527 introduced future year subtraction modifications for all property on which bonus depreciation was claimed – including MCIC assets. These modifications make the program's benefits more equitable, but will also necessitate businesses keeping separate state and federal depreciation records for the life of MCIC assets.

Chapter 527 also reduced the MCIC credit rate to 1.2% of the add-back from the previous rates of 7% for individuals or 9% for businesses. For Maine-only businesses, the 1.2% with accompanying new subtraction modification is roughly equal to the value of the prior MCIC rate. However, for multi-state businesses, the new 1.2% MCIC rate represents a decrease in the value of the program. Ironically, this means the more equitable distribution of benefits may actually make MCIC less likely to influence business investment. While the prior MCIC provided a higher benefit for multi-state businesses, the current version offers only a low value benefit of 1.2% to all eligible businesses and adds increased complexity.

Is MCIC likely to encourage businesses to expedite capital investment?

Studies of federal bonus depreciation generally have found it provides, at most, a modest impact on business investment decisions. MCIC is even less likely to have an impact because it provides less tax value than the federal bonus.

MCIC's Intent

To stimulate the Maine economy by encouraging businesses to expedite capital investments in Maine.

MCIC's Goal

To encourage businesses to expedite purchases of qualifying business property in Maine.

As established in the Evaluation Parameters for this review (Appendix E)

In general, business investment decisions are more likely to be driven by economic conditions and short-term sales and earnings outlook than by tax considerations[9]. Even when tax considerations are weighed in an investment decision, MCIC would be unlikely to significantly influence the decision because the program offers a low value benefit – the credit for tax year 2020 provides a discount of roughly 1% on the cost of an asset.

In addition, MCIC is based on federal bonus depreciation, which has been studied extensively. OPEGA relied on this research for an understanding of the potential effectiveness of federal bonus depreciation, and by extension, the potential effectiveness of MCIC. Taken together, we find these studies suggest that bonus depreciation has not had a significant impact on business investment. This finding suggests that MCIC is also not likely to significantly impact business investment.

Historically, many eligible taxpayers have not claimed bonus depreciation

Research out of the Department of Treasury's Office of Tax Analysis on federal bonus depreciation found that the take-up rate – the portion of eligible taxpayers that claim the bonus – for bonus depreciation is low. They cite this as a likely factor in the program's limited effect on investment. A 2016 study (Kitchen and Knittel) found that for the years 2002-2004 and 2008-2014 the take-up rate was between 40% and 60%[10]. This means that roughly half of taxpayers could have taken bonus depreciation, but chose not to.

Another study (Knittel 2007) identified two factors that could contribute to the low take-up rate for bonus depreciation. One factor was that many capital intensive firms had no taxable income as a result of losses during the period, or losses carried forward from prior tax years. Without taxable income they could not get any immediate value from bonus depreciation. Another factor was that many states did not conform to bonus depreciation, which the author thought might have discouraged use of bonus depreciation due to the added complexity for businesses filing in those states. [11]

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[9] Guenther, Gary. 2018. "The Section 179 and Section 168(k) Expensing Allowances: Current Law and Economic Effects." *Congressional Research Service*: 13-14.
[10] Kitchen, John and Matthew Knittel. 2016. "Business Use of Section 179 Expensing and Bonus Depreciation, 2002-2014." Department of Treasury's Office of Tax Analysis Papers. *OTA Working Paper 110: 33*
[11] Knittel, Matthew. 2007. "Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002-2004." Department of Treasury's Office of Tax Analysis Papers. OTA Working Paper 98.

When claimed, bonus depreciation has not been found to have a significant impact on capital investment

Unsurprisingly, there is no unanimous agreement about the effectiveness of federal bonus depreciation. However, a number of studies have found that bonus depreciation provides only a modest impact, if any. This finding has been fairly consistent despite the fact that studies covered different time frames with varying historical bonus depreciation rates.

A 2018 Congressional Research Service report cited a finding that, of the businesses that claimed bonus depreciation between 2002 and 2004, only 10% deemed it an important consideration in the timing or amount of investments.[12] A 2004 study (Desai and Goolsbee) found that the bonus depreciation allowed in 2002 and 2003 resulted in a relatively modest increase in investment – "only 1 to 2 percent."[13] This echoes the finding from a 2005 study (Knittel) that "the benefits of accelerated tax depreciation were not large enough to induce [firms] even to claim the provisions, let alone increase their investment in response to them."[14]

A number of studies also found that whatever effect bonus depreciation might have, the potential impact is limited to only long-term investments with longer depreciation horizons. Short-term investments already receive their depreciation allowances in a relatively short period of time, so the condensing of this time frame is of less value to firms than it is in the case of longer-lived capital goods. This may reduce the value of bonus depreciation as investment trends have shifted away from longer-term investments towards shorter-term investments – like computers – which receive less benefit from bonus depreciation.[15]

Another factor identified in the literature as potentially limiting the effectiveness of bonus depreciation is the move towards permanency for the provision. A 2014 Congressional Research Service report explained that "the temporary nature of bonus depreciation makes it, in theory, a more effective fiscal stimulus than other investment incentives because it is in the nature of a fire sale." The report's author cautioned that the "continual extension of [bonus depreciation]…may undermine the use of the provision in the future if firms expect the provision to last a long time."[16]

A recent article in the *American Economic Review* (Zwick and Mahom 2017)[17] departed somewhat from what was found in the studies mentioned previously. The authors found a larger impact attributable to bonus depreciation, but noted that the positive effect of bonus depreciation on investment is "concentrated exclusively among taxable firms." This highlights the fact that a tax deduction is of no value to a business that is losing money or has no taxable income. They also found the positive impact, for taxable businesses, to be "a relative investment response of

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[12] Guenther 2018: 12.
[13] Desai, Mihir and Austan D. Goolsbee. 2004. "Investment, Overhang, and Tax Policy." *Brookings Papers on Economic Activity*. Vol. 2:288.
[14] Knittel, Matthew. 2005. "Small Business Utilization of Accelerated Tax Depreciation: Section 179 Expensing and Bonus Deprecation," *National Tax Journal Proceedings, 98th Annual Conference*: 285.
[15] Cohen and Cummins. 2006: 2; Desai and Goolsbee 2004:321; House, Christopher L. and Matthew D. Shapiro. 2008. "Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation. *American Economic Review*. 98(3): 748.
[16] Gravelle 2014: 5
[17] Zwick, Eric and James Mahom. 2017. "Tax Policy and Heterogeneous Investment Behavior," *American Economic Review*. 107(1):240, 218.

10.4 percent on average between 2001 and 2004, and 16.9 percent between 2008 and 2010." However, the authors questioned whether researchers could consider this investment response new investment instead of simply a time shift of investment that would have happened anyway.

The literature cited in this section identifies, at most, a modest impact of bonus depreciation on business investment. MCIC is likely to have even less impact than bonus depreciation because the value of the credit is less than the value of the federal bonus, due to the fact that federal income tax rates are higher than State rates. For this reason, findings on the impact of federal bonus depreciation can be viewed as a cap of sorts on MCIC's potential impact on business investment.

Even if it doesn't encourage investment, some studies have found bonus depreciation may impact businesses in other ways

Much of the research suggesting bonus depreciation does have a positive impact for businesses has focused on business impacts other than increased investment. The 2018 Congressional Research Service report discussed the impacts found in a 2006 study as modest, representing "a cumulative increase in GDP of 0.07% to 0.14%" in 2002 and 2003.[18] In a 2017 presentation to the National Tax Association, Ohrn described that "bonus may have a significant effect on corporate behavior in important ways other than through capital investment" as the "additional cash generated by the policy may reduce the risk of bankruptcy and pay for investments in intangibles."[19] OPEGA cites these studies to note that bonus depreciation, and thus MCIC, may have other positive impacts for businesses apart from the goal of encouraging investment that was the focus of this report.

Is MCIC an effective way to encourage businesses to make capital investments in Maine rather than elsewhere?

MCIC provides some of the limited financial value of conformity, but none of the tax simplicity that makes conformity so desirable for businesses. This combination seems unlikely to encourage businesses to choose Maine over other states when making capital investments.

Conforming to bonus depreciation provides two benefits for businesses

State conformity to bonus depreciation benefits businesses in two ways that could potentially make a state more attractive for investment:

1. Financial Value – by extending the financial benefit of bonus depreciation to state income taxes; and

[18] Guenther 2018: 12
[19] Ohrn, Eric. 2017. "Do Investors Value Investment Tax Incentives? Evidence from Bonus Depreciation and the Fiscal Cliff." *National Tax Association, 110th Annual Conference on Taxation*: 31.

2. Simplification of Tax Compliance – by requiring less effort, and consequently cost, for businesses that would otherwise have to maintain separate state and federal depreciation records.

Of the states that impose income taxes, only about one-third[20] conform to federal bonus depreciation, providing businesses with both the financial value and tax simplification benefits of conformity.

Most states, like Maine, decouple from bonus depreciation, and some try to make decoupling easier on businesses

As noted previously, many states that impose income taxes decouple from bonus depreciation, like Maine. The choice to decouple prompts discussion of how state taxable income should be modified in order to remove the effects of bonus depreciation. Maine has chosen to decouple using addition and subtraction modifications in combination with the MCIC credit. Other states also use addition and subtraction modifications, and some have designed them in ways that could potentially make decoupling easier on businesses that claim federal bonus depreciation.

Among the states that decouple, a number have taken steps that seem intended to simplify the effects of decoupling on businesses. For example, some states simplify the add-back modification so that a taxpayer is not required to calculate what normal depreciation would have been, for each asset, absent the bonus. Minnesota's add-back is a straight 80% of federal bonus depreciation claimed, and North Carolina's add-back is 85% of bonus depreciation.[21]

Some states also simplify future year subtraction modifications. These approaches seem to facilitate decoupling without requiring a business to keep track of what depreciation would have been, absent the federal bonus, for the life of the asset. For example, Connecticut allows 25% of the bonus depreciation add-back to be subtracted in the four subsequent years. Florida allows corporations to subtract 1/7 of the add-back over the subsequent 7 years.[22] For assets with longer lives, these approaches also allow a business to receive more of the tax benefit of depreciation sooner rather than later.

Maine's uniquely complicated approach to providing some of the financial value of conformity seems unlikely to confer a competitive advantage

MCIC is unique among the states in that it attempts to approximate the financial value of conforming to bonus depreciation, only for assets located in the state. This limitation to assets within the State adds another layer of complexity to the already complicated requirements of decoupling. In fact, in a webinar about state tax treatment of depreciation, Bloomberg Tax analysts described Maine as one of the

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[20] OPEGA analysis of data obtained from NCSL summarizing state responses to bonus depreciation.
[21] Data obtained from NCSL summarizing state responses to bonus depreciation.
[22] Data obtained from NCSL summarizing state responses to bonus depreciation.

"particularly challenging states" and said the State's handling of federal bonus depreciation was "totally crazy and weird."[23]

If the financial value of MCIC were substantial, then perhaps it would be enough to drive businesses to invest in Maine rather than elsewhere. However, the credit's value is designed to approximate the financial value of bonus depreciation, and as discussed in the prior section, studies have not generally found bonus depreciation to have a significant impact on businesses' investment behavior. Based on the studies of the effect of bonus depreciation, MCIC's limited financial value seems unlikely to provide Maine with much of a competitive advantage.

On the other hand, the business community in Maine continues to stress, in discussions of state economic development strategy and tax expenditure evaluations, the importance of a simple and stable regulatory environment, including tax policies. MCIC requires businesses to wade through all the complexity of decoupling from bonus depreciation, and adds an additional layer of difficulty by necessitating that businesses track the physical locations of assets since only those located in Maine are MCIC eligible. This level of tax complexity, combined with the limited financial value of MCIC, does not seem likely to make Maine more attractive to investors considering other locations for their assets.

[23] Sheehan, Ryan, et al. 2019). "Unpacking the Challenges of State Tax Depreciation" [Webinar]. *Bloomberg Tax & Accounting*. Retrieved 10/10/19 (https://learning.bloombergtax.com/catalog/product.xhtml?eid=14417).

Findings

1 MCIC is a complicated response to bonus depreciation, and is unlikely to significantly affect capital investment in Maine

When the federal government makes changes to the Internal Revenue Code, states must choose whether or not to conform to those changes. As a compromise of sorts, Maine created MCIC as an alternative to federal bonus depreciation conformity. MCIC provides the approximate value of bonus depreciation to Maine taxpayers, but only for assets placed in service within the state. The resulting program is so uniquely complex that it is referred to as "totally crazy and weird" in a Bloomberg tax webinar on state depreciation. It has moved the state away from tax code simplicity – a tax policy best practice and factor in making Maine an attractive place to do business. In addition, this complexity does not appear justified because MCIC is not likely accomplishing its goal of encouraging businesses to expedite capital investments in Maine to any significant degree.

MCIC is complex for businesses. Research on the use of federal bonus depreciation finds that businesses are more likely to use bonus depreciation at the federal level when the states in which they file income taxes conform. This is because conformity significantly simplifies a business's depreciation bookkeeping. Decoupling, on the other hand, requires a business to separately track federal and state depreciation.

The combination of MCIC and Maine's bonus depreciation income modifications attempts to approximate the financial value of conformity for businesses. However, it also requires the extra bookkeeping associated with decoupling. For multi-state businesses, this extra bookkeeping is further complicated by the requirement to track the location of assets for which bonus depreciation was claimed. Tracking the location of assets is necessary because only those located in Maine qualify for MCIC.

MCIC is unlikely to encourage businesses to expedite their capital investments to any significant degree. Business investment decisions are more likely to be driven by economic conditions and short-term sales and earnings outlook than by tax considerations. This is particularly true for a tax incentive of limited value – like MCIC – which, in its most recent form, provides a reduction of roughly 1% to the cost of purchasing an asset. It is also of little to no value to businesses that have no tax liability.

Despite the fact that that federal bonus depreciation offers a higher value benefit than MCIC, research has not typically shown it to have a significant impact on business investment. In addition, research has shown that, historically, many firms with eligible investments have not taken advantage of the program.[24]

MCIC is unlikely to encourage businesses to choose Maine over other states when making capital investments. Although MCIC may help Maine approximate the value of bonus depreciation for some assets, it provides none of

[24] See page 7 for further discussion of the research reviewed for this evaluation.

the simplicity that makes conformity desirable for businesses. About 1/3 of states currently conform to federal bonus depreciation. By offering MCIC, Maine decouples while still offering a comparable benefit to bonus depreciation conformity for assets located in Maine. This could be argued to make Maine more competitive with other states. However, MCIC provides benefits in a way that may actually contribute to making Maine less attractive by diminishing the overall simplicity and predictability of the tax code. This may be why no other states currently offer a credit similar to MCIC as an approach to bonus depreciation.

Appendix A. Scope and Methods

The GOC-approved parameters for the evaluation of MCIC are detailed in Appendix E.

In the course of this evaluation, relevant information was obtained from the following sources:

- relevant statute, including the history of changes made since MCIC's enactment;
- testimony for MCIC bills that have come before the Legislature since the program's enactment;
- MRS forms 1040ME and 1120ME, as well as the MCIC claim form and supporting instructions;
- MRS guidance document "Modifications Related to Bonus Depreciation & Section 179 Expensing;"
- federal regulations related to bonus depreciation, including 26 U.S. Code §168(k);
- IRS forms 1040 and 1120, and related instructions;
- IRS Publication 946;
- state bonus depreciation conformity data obtained from the National Conference of State Legislatures;
- MRS's Maine State Tax Expenditure Report;
- interviews with program administrators at MRS;
- the 2019 Bloomberg Tax webinar entitled "Unpacking the Challenges of State Tax Depreciation;" and
- materials forwarded to the Taxation Committee by the GOC in response to a 2016 request for an OPEGA evaluation of the MCIC program.

OPEGA also reviewed the research on bonus depreciation, with a focus on its effectiveness as a tax incentive. We began with existing literature reviews by the Congressional Research Service, and then sought out other sources that offered a perspective on the effectiveness of bonus depreciation. We particularly sought out recent research and sources that were either peer-reviewed or had been presented at professional conferences or referenced by the work of others. The studies are not necessarily directly comparable, because they use different measures of effectiveness (take-up rates vs. economic impacts like GDP, employment, and stock prices), different time frames, different rates of bonus depreciation historically, and different populations of interest. However, taken together, we think they present a comprehensive view of the arguments being made about the potential utility of bonus depreciation.

Works cited include the following:

Cohen, Darrel and Jason Cummins. 2006. "A Retrospective Evaluation of the Effect of Temporary Partial Expensing." Finance and Economics Discussion Series, Federal Reserve Board.

Desai, Mihir and Austan D. Goolsbee. 2004. "Investment, Overhang, and Tax Policy." Brookings Papers on Economic Activity. Vol.2: 285- 355.

Gravelle, Jane G. 2014. "Bonus Depreciation: Economic and Budgetary Issues." Congressional Research Services Report.

Guenther, Gary. 2018. "The Section 179 and Section 168(k) Expensing Allowances: Current Law and Economic Effects." Congressional Research Service.

House, Christopher L. and Matthew D. Shapiro. 2008. "Temporary Investment Tax Incentives: Theory with Evidence from Bonus Depreciation." American Economic Review. 98(3): 737-768.

Kitchen, John and Matthew Knittel. 2016. "Business Use of Section 179 Expensing and Bonus Depreciation, 2002-2014." U.S. Department of Treasury's Office of Tax Analysis Papers. OTA Working Paper 110.

Knittel, Matthew. 2005. "Small Business Utilization of Accelerated Tax Depreciation: Section 179 Expensing and Bonus Depreciation." National Tax Journal Proceedings, 98th Annual Conference: 273-286.

Knittel, Matthew. 2007. "Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002-2004." U.S. Department of Treasury's Office of Tax Analysis Papers. OTA Working Paper 98.

Ohrn, Eric. 2017. "Do Investors Value Investment Tax Incentives? Evidence from Bonus Depreciation and the Fiscal Cliff." National Tax Association, 110th Annual Conference on Taxation. Retrieved on November 11, 2019 (cs.grinnell.edu/~ohrneric/files/Bonus_stocks/BONUS_EVENT_8_2017.pdf).

Zwick, Eric and James Mahom. 2017. "Tax Policy and Heterogeneous Investment Behavior." American Economic Review. 107(1): 217-248.

No confidential taxpayer data was obtained in the course of this evaluation.

Appendix B. Changes to Statutory Authorization for MCIC Since Enactment

Statutory Authorization for MCIC Since Enactment			
Public Law	LD and Session	36 MRSA Section	Tax Years Applied To
PL 2011, c. 380	LD 1043, 1st Reg 125th	§5219-GG	2011 - 2012
PL 2013, c. 368 (see RR 2013, c. 1)	LD 1509, 1st Reg 126th	§5219-JJ	2013
PL 2015, c. 1	LD 138, 1st Reg 127th	§5219-MM	2014
PL 2015, c. 388	LD 1583, 2nd Reg 127th	§5219-NN	2015 and later
PL 2019, c. 527	LD 1671, 1st Reg 129th	§5219-NN(1-A)	2020 and later

Appendix C. Analysis of the Impact of Changes in PL 2019, c. 527

Due to effects of apportionment, MCIC previously allowed greater financial benefits for multi-state businesses than for those that operate only in Maine.

A business's tax is apportioned – divided up among the states in which a business operates – in order to prevent the business from paying state level income taxes on the same income more than once. Apportionment for Maine income tax is based on the percent that Maine sales represent of the business's total sales in the United States.

$$\textbf{Apportionment factor} = \frac{\textbf{sales in Maine}}{\textbf{total sales in US}}$$

The apportionment factor affects a business's taxable income in Maine, but is not applied to Maine tax credits.[25] This is key, because prior to chapter 527, MCIC involved both a first-year credit – a tax benefit – and a first-year add-back – a tax detriment.[26] Multi-state businesses that took MCIC credits could receive the full tax benefit of the credit, because credits are not subject to apportionment. However, multi-state businesses did not experience the full detriment of the add-back. Instead, they experienced only a part of the tax effect of the add-back, based on their apportionment factor.

The examples below illustrate how the tax impact for multi-state vs Maine-only businesses changed due to chapter 527. All analyses focus on corporate taxpayers and attempt to isolate the effects of decoupling from bonus depreciation while holding all other factors constant. The analyses also assume:

- a Maine corporate income tax rate of 8.93%;
- a corporate MCIC rate of 9%;
- bonus depreciation claimed on an asset with initial value of $200,000 and a 7-year life that would otherwise be depreciated using the MACRS depreciation method.

Difference in Impact of MCIC on Maine-Only and Multi-State Businesses Prior to PL 2019, c. 527			
Maine-Only Business (No apportionment)	**Year 1**	**Multi-State Business (Assume 20% apportionment)**	**Year 1**
Federal bonus depreciation	200,000	Federal bonus depreciation	200,000
Normal Depreciation	28,580	Normal Depreciation	28,580
Maine add-back (bonus - normal depreciation)	171,420	Maine add-back (bonus - normal depreciation)	171,420
Tax effect of add-back (add-back x 8.93%)	15,308	Tax effect of add-back (add-back x 8.93% x 20%)	3,062
MCIC credit (add-back x 9%)	(15,428)	MCIC credit (add-back x 9%)	(15,428)
Total tax effect	**(120)**	**Total tax effect**	**(12,366)**

Changes enacted by the 129th Legislature made the benefits of MCIC more equitable for Maine-only and multi-state businesses.

PL 2019, c. 527 addressed the inequity that previously existed in MCIC by introducing subtraction modifications for tax years subsequent to when MCIC was claimed.[27] The subtraction modifications redistribute the depreciation that the add-back had taken away in year one to future years, when that depreciation would have otherwise been claimed absent bonus depreciation. Under this new version of MCIC, multi-state businesses will still have access to greater tax impacts in the year that a qualifying asset is purchased. However, over the life of the asset, the subtraction modification has the

25 MRS Rule No. 801, Apportionment of Income.

26 Title 36 §5219-NN, §5122(1)(KK)(1) and §5200-A(1)(CC)(1)

27 Title 36 §5122(2)(RR) and §5200-A(2)(FF)

effect of netting to zero the tax effect of the add-back in year one – whether that add-back was apportioned or not. This effect is illustrated in the example that follows.

Difference in Impact of MCIC on Maine-Only and Multi-State Businesses Under PL 2019, c. 527									
Maine-Only Business (No apportionment)	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Total**
Federal bonus depreciation	200,000								
Normal Depreciation	28,580								
Maine add-back or subtraction (bonus - normal depreciation)	171,420	(48,980)	(34,980)	(24,980)	(17,860)	(17,840)	(17,860)	(8,920)	0
Tax effect of modification (modification x 8.93%)	15,308	(4,374)	(3,124)	(2,231)	(1,595)	(1,593)	(1,595)	(797)	0
MCIC credit (add-back x 9%)	(15,428)								(15,428)
Total tax effect	**(120)**	**(4,374)**	**(3,124)**	**(2,231)**	**(1,595)**	**(1,593)**	**(1,595)**	**(797)**	**(15,428)**
Multi-State Business (Assume 20% apportionment)		**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**	**Year 8**	**Total**
Federal bonus depreciation	200,000								
Normal Depreciation	28,580								
Maine add-back or subtraction (bonus - normal depreciation)	171,420	(48,980)	(34,980)	(24,980)	(17,860)	(17,840)	(17,860)	(8,920)	0
Tax effect of modification (modification x 8.93% x 20%)	3,062	(875)	(625)	(446)	(319)	(319)	(319)	(159)	0
MCIC credit (add-back x 9%)	(15,428)								(15,428)
Total tax effect	**(12,366)**	**(875)**	**(625)**	**(446)**	**(319)**	**(319)**	**(319)**	**(159)**	**(15,428)**

Appendix D. Maine's Tax Expenditure Review Process

OPEGA conducts reviews of tax expenditures in accordance with Title 3 §§998 and 999. Tax expenditures are defined by Title 5 §1666 as "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." Tax expenditure reviews fall into one of two categories, full evaluation and expedited review. The GOC, in consultation with the Joint Standing Committee of the Legislature having jurisdiction over taxation matters, assigns a category to tax expenditures and establishes a prioritized schedule for the reviews.

The tax expenditure review process was established as the result of Resolves, 2013, chapter 115, which directed OPEGA to develop a proposal to be considered by the Joint Standing Committee on Taxation during the 127th Legislative Session. On March 2, 2015, OPEGA submitted the report outlining the proposal for implementing ongoing reviews and included a chart of identified tax expenditures (http://mainelegislature.org/doc/578). The report states that the purposes of establishing a formal, ongoing legislative review process are to ensure that:

- Tax expenditures are reviewed regularly according to a strategic schedule organized so that tax expenditures with similar goals are reviewed at the same time;
- Reviews are rigorous in collecting and assessing relevant data, determining the benefits and costs, and drawing clear conclusions based on measurable goals; and
- Reviews inform policy choices and the policymaking process.

The proposal became LD 941 An Act to Improve Tax Expenditure Transparency and Accountability and was enacted as Public Law 2015, chapter 344. Part of this law, Title 3 §999, provides that the GOC establish parameters for each full review based on the following:

- 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;
- The intended beneficiaries of the tax expenditure;
- The evaluation objectives, which may include an assessment of:
  - The fiscal impact of the tax expenditure, including past and estimated future impacts;
  - 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;
  - 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;
  - The extent to which those actually benefiting from the tax expenditure are the intended beneficiaries;
  - 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;
  - The extent to which the State's administration of the tax expenditure, including enforcement efforts, is efficient and effective;
  - 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;
  - 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
  - Any opportunities to improve the effectiveness of the tax expenditure in meeting its purposes, intent or goals; and
- 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.

Appendix E. GOC Approved Evaluation Parameters

**Parameters for OPEGA's Full Evaluation of the
Maine Capital Investment Credit (MCIC)
as approved by the Government Oversight Committee 5-12-17**

Enacted	Statute(s)	Type	Category	Est. Revenue Loss
2011	36 MRSA §5219-GG 36 MRSA §5219-JJ 36 MRSA §5219-MM 36 MRSA §5219-NN	Income Tax Credit	Conformity with IRC	FY18 $9,350,000 FY19 $5,950,000

Source for Estimated Revenue Loss: Maine State Tax Expenditure Report 2018 – 2019.

Program Description

The Maine Capital Investment Credit (MCIC) is a personal and corporate income tax credit for depreciable property placed in service in Maine. Although this credit is categorized as "conformity with IRC" (Internal Revenue Code), the credit does not actually conform to the federal tax code. Instead, it is a Maine-specific credit that is based on a federal depreciation deduction – both of which provide a tax benefit associated with purchases of new depreciable property.

The State's response to the federal bonus depreciation deduction enacted in 2001 has varied over time from full conformity to a complete decoupling. Currently, MCIC allows a Maine taxpayer who claims the federal bonus depreciation deduction under US Code, Section 168(k) to claim a credit on their Maine taxes for a percentage of the federal depreciation reduced by the depreciation that would have been allowed in the first year if bonus depreciation did not exist. For tax year 2016, the credit was 9% for corporations and 7% for individuals.

$$\text{2016 MCIC credit} = \left[\begin{array}{c}\text{9\% for corporations or}\\ \text{7\% for individuals}\end{array}\right] \times \left[\left(\begin{array}{c}\text{amount of federal}\\ \text{bonus depreciation for}\\ \text{Maine equipment}\end{array}\right) - \left(\begin{array}{c}\text{amount of federal}\\ \text{depreciation for Maine}\\ \text{equipment allowed in } 1^{st}\\ \text{year if bonus didn't exist}\end{array}\right)\right]$$

In prior years, the MCIC percentages have ranged from 8-10% and the calculation has varied as dictated by State statute, with a factor based on what proportion of the depreciable property is located in Maine. The calculations for this credit, as well as annual State and federal rule changes, are very complex as evidenced by the 60 page guidance document Maine Revenue Services (MRS) provides for taxpayers affected by bonus depreciation.

Property must be used within the State of Maine for the entire 12-month period beginning with the date the property is placed in service in Maine or else the credit may be recaptured. In addition, some property is excluded from the MCIC credit, including:

- property owned by a public utility;
- property owned by a person that provides radio paging services;
- property owned by a person that provides mobile telecommunications services;
- property owned by a cable television company;
- property owned by a person that provides satellite-based direct television broadcast services; and
- property owned by a person that provides multichannel, multipoint television distribution services.

The credit is non-refundable and may be carried forward for up to 20 years. Maine taxpayers are only eligible to take the MCIC credit if they qualified for, and claimed, the associated federal bonus depreciation deduction. To receive the MCIC tax credit, a business must complete the MCIC income tax credit worksheet. The MCIC is administered solely by MRS, which reviews and processes the MCIC income tax return worksheets.

There is currently no sunset, or end date, for the MCIC credit in Maine statute. However, since the credit is based on the federal bonus depreciation it would become a $0 credit if the federal bonus depreciation deduction ended. The federal bonus depreciation deduction is currently scheduled to sunset in 2019. However it is unclear whether the sunset will actually occur as the deduction has been extended beyond sunset dates in prior years.

Evaluation Parameters Subject to Committee Approval

The following parameters are submitted for GOC approval as required by 3 MRSA §999 subsection 1, paragraph A.

(1) Purposes, Intent or Goals

Intent — To stimulate the Maine economy by encouraging businesses to expedite capital investments in Maine.

Goal — To encourage businesses to expedite purchases of qualifying business property in Maine.

(2) Beneficiaries

Primary Intended Beneficiaries — Businesses investing in qualifying business property in Maine.

(3) Evaluation Objectives

Below are the objectives the evaluation proposes to address. The objectives are coded to indicate which of the performance measures in section (4) below could potentially be applicable.

Each objective will be explored to the degree possible based on its relevance, the level of resources required and the availability of necessary data. Any substantial statutory changes since the program's enactment will be considered in addressing objectives impacted by those changes.

Objectives	Applicable Measures
1) The fiscal impact of the tax expenditure, including past and estimated future impacts;	B, C, G Qualitative
2) The extent to which the design of the tax expenditure supports achievement of the tax expenditure's purposes, intent or goals and consistent with best practices;	Qualitative
3) 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;	A, B, C, E, F, G, H, I Qualitative
4) The extent to which those actually benefiting from the tax expenditure are the intended beneficiaries;	A, B, I, D Qualitative
5) 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;	B, D, E, F Qualitative
6) The extent to which the State's administration of the tax expenditure, including enforcement efforts, is efficient and effective;	Qualitative
7) The extent to which the tax expenditure is coordinated with, complementary to or duplicative of federal bonus depreciation or other similar initiatives;	Qualitative
8) The extent to which the tax expenditure is a cost-effective use of resources; and	C, F, G, H Qualitative
9) Any opportunities to improve the effectiveness of the tax expenditure in meeting its purposes, intent or goals.	Qualitative

OPEGA will perform additional work as necessary, and as possible within existing resources, to provide context for OPEGA's assessment of this program in Maine, including review of literature or reports concerning these programs nationally or in other states.

(4) Performance Measures

Performance measures are coded to indicate which of the above objectives they could potentially help address. Measures will be calculated to the degree possible based on the level of resources required and the availability of necessary data.

A	# Total businesses receiving any benefits under the MCIC
B	Total $ value of MCIC tax credits received by businesses (direct tax revenue lost)
C	Total direct program cost (credits plus administrative costs)
D	Average tax benefit per business, including min & max
E	Estimated value of eligible property associated with MCIC claims
F	Indicators of changes in the timing of business investments in qualifying business property
G	Net impact on State budget (using economic modeling, as possible and appropriate, to include indirect benefits and costs)
H	Indicators of economic growth associated with the program since its enactment (such as change statewide employment or GDP – using economic modeling, as possible and appropriate, to include capture of indirect benefits and costs)
I	Participation rate: comparison of number of businesses claiming MCIC to number of businesses filing taxes in the state

Performance measures would typically be calculated by year to allow for analysis of percentage changes year over year, trends, etc. Further calculations and breakouts that would be considered, as appropriate, include:

- per capita,
- comparison to industry or geographic trends,
- by business sector,
- by new vs. continuing beneficiary,
- by county or municipality,
- by firm size,
- by apportionment factor.