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REPORT OF
THE JOINT STANDING COMMITTEE
ON TAXATION
REGARDING

TAX EXPENDITURE REVIEW

JANUARY, 1986

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BACKGROUND

In 1978, the 109th Legislature, enacted legislation which required the Joint Standing Committee on Taxation to review sales and property tax exemptions over a four year period. The schedule provided for the review of one half of the exemptions in each category in each year through 1982. The following year, the law was changed to provide for a four year revolving review of the specified exemptions. It also changed the schedule of review to provide that all sales tax exemptions would be reviewed in one year and all property tax exemptions two years later. The reviews required were conducted and reports are available. Although a few significant changes were occasionally recommended, only minor amendments to the tax law have actually been enacted as a result of prior reviews.

In 1981, legislation was enacted requiring the State budget document to contain the estimated loss of revenue resulting from tax expenditures. "Tax expenditures" is defined as "state tax revenue losses attributable to provisions of Maine tax laws which allow a special exclusion, exemption or deduction or which provide a special credit, a preferential rate of tax or a deferral of tax liability." These estimates are prepared

biennially by the Bureau of Taxation for inclusion within the Governor's budget document.

In 1985, L.D. 1521, AN ACT to Provide for Greater Tax Expenditure Accountability, was referred to the Taxation Committee. This bill provided for a review by the Finance Authority of Maine of new tax expenditure legislation both before and after enactment. The bill was amended in Committee to provide for a review of tax expenditure provisions by the Taxation Committee on a four year rotating basis with those provisions expiring unless they were reenacted by the Legislature. The bill was amended on the floor to remove the automatic expiration provision but retain the rotating review provisions. This report is prepared pursuant to the requirements of that legislation.

PROCEDURE

Pursuant to Title 36 of the Maine Revised Statutes Annotated, chapter 9, the Taxation Committee is required to review by January 1, 1986 the tax expenditures contained in

Title 36, Section 1752;

Title 36, Section 1760, subsections 1 to 9-C;

Title 36, Chapter 357.

The Committee is required to hold a public hearing on the provisions subject to review to provide an opportunity for public comment. A public hearing was held on October 16, 1985. A few persons representing major interest groups attended. No one presented oral or written testimony.

The Committee considered the provisions individually at work sessions during the fall and decided to give in depth attention to several provisions.

ELECTRICITY USED IN AN ELECTROLYTIC PROCESS

Title 36, Section 1752 excludes from the sales tax electricity which is separately metered and consumed in an electrolytic process for the manufacture of tangible personal property for later sale. This exclusion was originally enacted in 1975 to assist a chemical production facility in Orrington which uses electricity in an electrolytic process in the production of chlorine which is sold for use primarily in the paper manufacturing process. The general manager attended a work session of the Committee at the request of the Committee and provided information relating to the value of the exemption to the company. This one company is the only known beneficiary of the exclusion. The general manager told the Committee that the value of the exclusion to the company was approximately \$344,000 annually. He stated that the company believed that the exclusion was justified because the electrolytic process uses electricity as a raw material which ought to be exempt from the sales tax like other raw materials used in manufacturing.

The Committee decided that the original purpose of the exemption continued to be fulfilled and decided to recommend no change in the exclusion.

INSURANCE TAX

Maine has taxed foreign insurance companies since 1876; domestic companies since 1985. The structure of the tax has not changed much in recent years.

The Committee considered in some depth several provisions of the insurance tax law which include tax expenditures. The Committee discussed primarily the preferential tax rate for domestic insurers and the exclusion from the tax of nonprofit hospital or medical service organizations (Blue Cross and Blue Shield).

Preferential domestic rate

Title 36, Chapter 357 provides that domestic insurers are taxed at a rate of 1% of gross premiums. All other insurance companies are taxed at the rate of 2%. The preferential rate for domestic insurers has become an issue because of the recent decision of the United States Supreme Court in Metropolitan Life Insurance Co. v. Ward, U.S. (March 26, 1985), in which an Alabama insurance tax provision giving preferential rates to domestic insurers was challenged under the equal protection clause of the United State Constitution. The Alabama law permitted foreign insurers to receive a reduced rate if they made certain investments in Alabama or had their home office there; however, foreign companies could never reduce their rate to the same level as domestic insurers. The State argued that the rate distinction was justified because it was intended to promote local business and investment. The Supreme Court ruled that it was not a legitimate State purpose

to encourage domestic business by discriminating against foreign business and remanded the case to the Alabama courts for consideration of other justifications which the State had raised but which had not been decided originally. A strong dissent argued in favor of the permissibility of the State's purpose of encouraging domestic business.

The Ward case raises the question of the constitutionality of the rate differential in Maine's insurance tax law. The current differential has been in existence since 1939. Limited legislative debate mentioned that reducing the rate for domestic insurers to 1% was "fair." The most obvious effect of the differential is to provide a competitive advantage to domestic insurers. Other purposes are not readily apparent. Modern viewers are left to hypothesize about the reason for the differential as neither the Maine law nor the legislative history are helpful on that question. Differential rates have traditionally been nearly universal among states with insurance taxes, although there appears to be a recent trend toward elimination of the differentials.

After Ward it seems quite likely that the Maine differential may be unconstitutional. Several insurers have filed their tax returns "under protest" in the last few years. No law suit has yet been filed. If the State were ordered to return amounts paid under protest over the last three years, the total could exceed \$25,000,000; however, the legal framework is quite complicated, and it seems unlikely that such a large liability would result.

The Taxation Committee considered the possibility of equalizing the tax rates for all insurers. Currently, the State collects approximately \$18,100,000 from the insurance premium tax. If the rate for all insurers was 1%, the amount of revenue is estimated to be \$9,700,000; at 2% for all insurers, the revenue would be \$19,500,000. The Bureau of Taxation estimates that a uniform rate of 1.87% would result in revenue approximately equal to what is collected under the current structure.

Another possibility discussed by the Committee at its last meeting was the possibility of changing to a rate of 1% on all health insurance and 2% on all other insurance. The Committee finds that additional time is necessary to consider fully the legal implications of the recent United States Supreme Court decision and to consider all of the implications of different rates of taxation for different kinds of insurance. For this reason and the ones described in the next section, the Committee is recommending legislation which would require it to study selected issues relating to the taxation of insurance and report legislation to the 112th Legislature regarding this issue.

Nonprofit hospital or medical service organizations

Currently, nonprofit hospital or medical service organizations are exempt from the insurance premium tax. These organizations are the Blue Cross and Blue Shield group of insurers. When originally established, these organizations

were intended to perform a public service function not provided by other insurance companies. In recognition of this public service function, these organizations were exempted from the insurance premium tax.

Over the years, the distinction between Blue Cross/Blue Shield and other insurance companies has diminished. Although the organization has traditionally received special treatment under federal tax laws, the tax reform bill passed by the United States House of Representatives in December 1985 would remove that special treatment.

In the last session of the Legislature, a bill was introduced which would have permitted Blue Cross/Blue Shield to market a new form of insurance called comprehensive insurance which would place Blue Cross/Blue Shield in more competition with other insurance companies which are required to pay the tax. Blue Cross/Blue Shield was willing to pay a tax on 10% of the premiums resulting from the new contracts to approximate the amount of premiums that should be attributed to the ability to provide the new service. That bill was not enacted because it would have resulted in a loss of revenue from the insurance premium tax caused by the transfer of business from other insurers who are subject to the tax.

Because this issue was raised relatively late in the process of the Committee's study of the insurance premium tax, the Committee did not have sufficient time to investigate all of the potential implications of removing the tax exemption for nonprofit hospital and service organizations. Therefore, the

Committee is recommending legislation to require it to study this issue and report legislation to the Second Regular Session of the 112th Legislature.

TAX EXPENDITURES SUBJECT TO REVIEW

Section 1752

Section 1752 of Title 36 contains the definitions of terms used throughout the sales tax law. In the process of establishing these definitions the Legislature excluded from taxation certain sales.

A. Purpose. The purpose of these exclusions is to aid in the administration of the sales tax or to avoid the possibility of double taxation of items that will be taxed in a subsequent resale. Most of the exclusions are standard exclusions which are common to nearly all sales tax systems.

B. Persons benefited. The individuals and groups benefiting from these exclusions are the persons who would be responsible for paying the sales tax if it were due. The general public benefits to the extent that the exclusions keep Maine in line with the tax policies of other states or encourage economic development by providing a benefit that is not provided elsewhere.

C. Effectiveness. The Committee finds that these exclusions have been effective in accomplishing the purpose for which they were intended.

D. Cost. The estimate of the cost of these expenditures is based upon information developed by the Bureau of Taxation and is as follows:

1.	Casual sales	\$250,000-\$1,000,000
2.	Sales by executor	0-\$50,000
3.	Electricity in electrolytic process	\$344,000
4.	Components in manufacturing	\$140,300,000
5.	Personal property consumed in manufacturing	\$14,030,000
6.	Rentals to persons in the business of renting autos	0-\$50,000
7.	Sales to persons in the business of renting autos	\$50-\$250,000
8.	Containers	\$6,903,000
9.	Fairs and rummage sales	\$7,500
10.	Labor service fees	\$6,274,000
11.	Tips to employees	\$102,000
12.	Meals and lodging to employees	\$150,000
13.	Long distance telephone and directory service	\$4-5,000,000

E. Recommendation. The Committee recommends no change in the tax expenditures provided by this section.

Section 1760 (subsections 1 to 9-C) (sales tax exemptions)

Section 1760 contains the listing of exemptions that have been provided from the sales tax. These exemptions have previously been studied by the 110th Legislature under the review procedure that existed at that time. That report, Report of the Joint Standing Committee on Taxation to the 110th Legislature on the Statutory Review of the Sales and Use Tax Exemptions Contained in Title 36, Section 1760, contains a more in depth discussion of the origin of the sales tax exemptions. This Committee believes that that information is still accurate, and believes that repetition is not needed.

A. Purpose. The purpose of the sales tax exemptions subject to review has been identified in the report of the Taxation Committee of the 110th Legislature. There has been no change since that time in the purpose of the sections subject to review here.

B. Persons benefited. This determination was also made by the previous report. This Committee has identified no changes since that time.

C. Effectiveness. The Committee finds that these tax expenditures continue to be effective in accomplishing the purpose for which they were intended.

D. Cost. The estimate of the cost of these expenditures is based upon information developed by the Bureau of Taxation and is as follows:

1.	Sales prohibited by the federal and state constitutions	\$1-3,000,000
2.	State and political subdivisions	over \$6,000,000
3.	Products for human consumption	\$58,480,000
4.	Ships stores	\$260,000
5.	Medicines for human beings	\$3,174,000
6.	Prosthetic devices	\$1,570,000
7.	Meals served by public or private schools	\$2,996,000
8.	Meals to patients, hospitals and nursing homes	\$3,412,000
9.	Meals for the elderly	\$5,200
10.	Products used in agricultural production	\$6,735,000
11.	Coal, oil, wood for cooking and heating homes	\$15,248,000
12.	Fuel oil for burning blueberry land	\$33,800
13.	750 KWH of residential electricity per month	\$7,822,000
14.	Gas used for cooking or heating	\$1,059,000

Chapter 357 (insurance tax)

The insurance premium tax contains three provisions which qualify as tax expenditures:

- A. Purpose. The purpose of the reduced rate for domestic insurers is discussed previously in this report.
- B. Persons benefited. Persons benefiting from the reduced rate for domestic insurers are domestic insurance companies.
- C. Effectiveness. The Taxation Committee finds that domestic insurance companies have been better able to compete with foreign companies to the extent that they may pay a reduced tax rate.
- D. Cost. The estimate of the cost of these expenditures is based upon information developed by the Bureau of Taxation and is as follows:

1. Reduced rate for domestic insurers	\$1,400,000
2. Insurance Company Specific Deductions	\$50,000-250,000
3. Deduction of Dividends and direct return premiums	0-\$50,000

- E. Recommendation. For the reasons discussed above, the Committee recommends further study of the reduced rate for domestic insurers.

(4441)

SECOND REGULAR SESSION

ONE HUNDRED AND TWELFTH LEGISLATURE

Legislative Document

No.

STATE OF MAINE

IN THE YEAR OF OUR LORD
NINETEEN HUNDRED AND EIGHTY SIX

AN ACT Relating to the Taxation
of Insurance Premiums.

Be it enacted by the People of the State of Maine as follows:

Sec. 1. Study. The Joint Standing Committee of the Legislature having jurisdiction over taxation shall continue its study of the taxation of insurance including the need for changes in the tax preference rate for domestic insurers and the desirability of continuing the tax exemption for nonprofit hospital and service organizations.

Sec. 2. Legislation. The Committee shall report legislation to the Second Regular Session of the 112th Legislature by March 17, 1986 containing its recommendations with regard to its study conducted under this Act.

STATEMENT OF FACT

This bill is the recommendation of the Joint Standing Committee on Taxation resulting from its statutory review of tax expenditures. The bill requires that Committee to continue its review of insurance taxes and report legislation to this session of the Legislature.