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Maine Gears Up for a Serious Tax Reform Conversation

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Key Findings

- With his newly released tax reform proposal, Governor Paul LePage becomes the first governor to propose substantive tax reform in 2015.
- The plan would result in a tax cut of $267 million per year as of FY 2019, with the plan fully phased in by the start of calendar year 2021.
- If fully implemented, the LePage plan would improve the state's ranking from 33rd to 23rd on the Tax Foundation State Business Tax Climate Index.
- The governor proposes cutting income tax rates for all income levels but with a more progressive structure that includes additional brackets and a "bubble" bracket designed to phase out the state's zero bracket for higher income earners.
- The LePage plan flattens the corporate income tax and cuts rates while eliminating preferences favoring specific industries and activities.
- To offset income tax reductions, the governor proposes broadening the sales tax base and raising rates.
- The plan also proposes repealing the estate tax and limiting property tax exemptions, along with the elimination of state-local revenue sharing and adjustments to existing state spending limitations.
- The LePage plan could be improved by reforming the state's net operating loss carryback system.

Overview

Governor Paul LePage of Maine is the first governor to put a serious tax reform proposal up for conversation in 2015. Among other provisions, the plan would lower top individual and corporate income tax rates while broadening tax bases, expand the sales tax base to some services while exempting business inputs, raise the sales tax rate while providing a refund for low-income taxpayers, and repeal the state's estate tax.

When Governor LePage took office, we ranked Maine 37th in our *State Business Tax Climate Index*, and during his first term, that ranking improved slightly to 33rd. Should Maine's legislature adopt the governor's proposal, Maine would move to 23rd in our rankings, reflecting improvements in both rates and structure.

Individual Income Tax

In 2011, Governor LePage successfully oversaw the adoption of a tax reform package that reduced the individual income tax, bringing the top rate down from 8.5 percent to 7.95 percent. In this new proposal, the individual income tax component is more ambitious in terms of rate cutting but also introduces structural changes that do not score as well in our model.

The plan simplifies the individual income tax by eliminating a range of credits and deductions, cutting rates, and adjusting income modifications. Once fully phased in, the proposed tax reform package would drop the highest rate from 7.95 percent to 6.5 percent, though due to a tax rate "bubble" mechanism explained below, the rate on income above $175,000 would actually be lower, settling at 5.75 percent. All told, these reforms will result in a $1.2 billion cut in individual income taxes over the FY 2018–2019 biennium.

Rate Changes

Under current law, Maine's individual income tax has three tax brackets.

Table 1. Maine Individual Income Tax Brackets (current law)

Bracket	Rate
$0–$5,300	0%
$5,301–$21,200	6.5%
≥ $21,201	7.95%

Note: Brackets shown for single filers. For head of household, multiply by 1.5; for married filing jointly, multiply by 2.

Under Governor LePage's plan, the state would adopt four brackets, nearly double the amount of income exempt from taxation, and lower rates for all income levels. In Figure 1, changes from the previous year are presented in bold.

Figure 1. Proposed Maine Individual Income Tax Bracket Changes, 2016–2019

Tax Year 2016		Tax Year 2017		Tax Year 2018		Tax Year 2019	
Bracket	Rate	Bracket	Rate	Bracket	Rate	Bracket	Rate
$0	0%	$0	0%	$0	0%	$0	0%
$9,701	**5.75%**	$9,701	5.75%	$9,701	5.75%	$9,701	5.75%
$50,001	**6.95%**	$50,001	**6.95%**	$50,001	**6.75%**	$50,001	**6.5%**
		$128,101	**6.5%**	**$143,726**	**6.0%**	**$175,000**	**5.75%**

Note: Brackets shown for single filers. For head of household, multiply by 1.5; for married filing jointly, multiply by 2.

One notable feature of the plan is a "bubble bracket" that, once fully phased in, will cover income from $50,001–$175,000. The higher rate for this bracket is intended to phase out the benefit of the zero bracket for taxpayers with income above $50,000. Several other states have personal exemption phase-out (PEP) mechanisms that have similar economic effects on marginal rates, but Maine would be the only state to explicitly put the rate effects into the brackets themselves.

The use of a bubble bracket, or any other personal exemption phase-out mechanism, will necessarily have some dampening effect on economic activity among earners within that bracket, and the addition of a new tax bracket makes the income tax more progressive (which is reflected adversely in our scoring). Still, under this plan, all earners would pay less in income taxes than they do now, and overall, the income tax cut in the plan would improve the state's score in the income tax component of our *State Business Tax Climate Index*.

Income Modifications

Within the income tax system, an individual's adjusted gross income (AGI) is their gross income minus deductions, which yields taxable income. For instance, at both the federal and the state level, certain business expenses, IRA and health savings account contributions, and moving expenses can be deducted (among other qualifying expenditures). States largely follow the federal model and rely on federal adjusted gross income (FAGI) for state income tax purposes, but often differ on specific income modifications, allowing additional subtractions from FAGI in some areas while requiring additions for state income tax purposes in others.

Under the proposed legislation, up to $35,000 (inflation adjusted) in income modifications can be claimed per beneficiary upon full phase in (rising in $5,000 annual increments), up from $10,000 at present. Employee contributions to the Maine Public Employees Retirement System would be made tax exempt, while subtractions from FAGI for long-term care insurance premiums not already subtracted at the federal level would be eliminated. Similarly, the deduction of up to $250 per beneficiary for 529 plan contributions would be eliminated. Taken as a whole, the LePage proposal expands the availability of income modifications and creates greater conformity with federal measures of adjusted gross income.

Credits, Deductions, and Exemptions

This plan chisels away at non-neutral elements of the current income tax, maintaining personal exemptions and conformity with the federal standard deduction but repealing itemized deductions (including the charitable deduction) and certain credits, including the earned income tax credit, which is currently equal to 5 percent of the federal credit. A notable exception is the dependent care tax credit, which LePage's plan would apply equally (at the higher rate) to children sent to all child care facilities, in contrast to the current rate differential that favors facilities and homes with a "quality certificate."

Corporate Income Tax

Governor LePage proposes to consolidate the number of corporate income tax brackets and bring down rates over time, with partially offsetting reductions in tax preferences for industries that currently enjoy privileges in the tax code. Taken in aggregate, these modifications to the corporate income tax will result in an estimated $50 million cut over the FY 2018–2019 biennium, causing Maine to leapfrog from 45th to 17th in the corporate tax component of our *State Business Tax Climate Index*.

Rate Changes

Under current law, Maine's corporate income tax has four brackets.

Table 2. Maine Corporate Income Tax Brackets (current law)

Bracket	Rate
$0–$25,000	3.5%
$25,001–$75,000	7.93%
$75,001–$250,000	8.33%
≥ $250,001	8.93%

The tax reform proposal under consideration would cut rates and consolidate brackets over time, with the top rate declining to 6.75 percent by 2021, compared to a current rate of 8.93 percent (see Figure 2). Although the LePage plan would not make Maine the thirtieth state with a flat corporate income tax—there is no compelling policy rationale for disparate treatment of corporate income—by having the top rate kick in for all income above $25,000, the plan brings the state much closer to one.

Figure 2. Proposed Maine Corporate Tax Bracket Changes, 2017–2021

Tax Year 2017		Tax Year 2018		Tax Year 2019		Tax Year 2020		Tax Year 2021	
Bracket	Rate	Bracket	Rate	Bracket	Rate	Bracket	Rate	Bracket	Rate
$0	3.5%	$0	3.5%	$0	3.5%	$0	3.5%	$0	3.5%
$25,001	7.93%	$25,001	7.93%	$25,001	7.5%	$25,001	7.0%	$25,001	6.75%
$75,001	8.33%	Top bracket repealed							
Top bracket repealed									

LePage also proposes to repeal the state's corporate alternative minimum tax (AMT), which currently applies to 5.4 percent of federal alternative minimum taxable income (with adjustments). At present, Maine is one of only eight states to impose an AMT on corporations. Evidence shows that AMTs create high compliance costs while netting little revenue and failing to improve the equity of the tax system in any meaningful way.

Credits

LePage's plan envisions lower corporate tax rates on a broader income base, eliminating exemptions that favor specific industries or activities, including (but not limited to) the repeal of the

- High-Tech Credit,
- Jobs and Investment Tax Credit,
- Biofuel Production Tax Credit, and
- Employer credits for payment of employee expenses.

Although states often tout business incentives as tools to promote economic development, narrow incentives like these distort economic decision-making; in the long run, lower, simpler taxes are more conducive to sustained economic growth. The tax reform proposal on the table in Maine takes an important step in the right direction by eliminating special deals for favored businesses and instead focusing on making Maine's business tax climate more competitive across the board.

Sales Tax

The plan also proposes broadening the sales tax base and raising rates, albeit in the context of a broader plan that has the overall effect of cutting taxes. All told, the sales tax increase and expansion is estimated to raise an additional $831 million over the FY 2018–2019 biennium, dropping the state from 9th to 20th on the sales tax component of the *Index*.

Rate Changes

At present, sales taxes are scheduled to be cut across most categories on July 1, 2015. Governor LePage proposes abandoning some of those scheduled cuts and even raising rates for some categories, along with a fairly sizeable expansion of the base (see Table 3). Since sales taxes are generally less economically disruptive than some other forms of taxation, including income taxes, a tax shift from earnings to consumption has the potential to improve the state's economic outlook.[1]

Table 3. Maine Sales & Use Taxes (current and proposed)

Sales & Use Tax Type	Current	Scheduled	Proposed
General Sales & Use Tax Rate	5.5%	5.0%	6.5%
Service Provider Tax	5.0%	5.0%	6.0%
Lodging	8.0%	7.0%	8.0%
Prepared Foods (including alcohol)	8.0%	7.0%	6.5%
Short-Term Auto Rentals	10.0%	10.0%	8.0%

Base Expansion

At present, Maine—like most states—relies on a narrow sales tax base that exempts many goods and nearly all services. This antiquated, non-neutral approach does a poor job of reflecting the economy of Maine or the nation as a whole, which is why economists and finance scholars overwhelmingly advocate for broad bases and low rates. An ideal sales tax would cover the final sale of all goods and services but exempt business-to-business transactions to avoid tax pyramiding.[2]

Currently, Maine's sales tax base consists of the sale of tangible personal property with the exception of groceries (not including prepared foods), prescription medication, residential fuel oil, and certain other "necessities of life," and also captures a few select services, such as leasing an automobile or renting living quarters in a hotel. Governor LePage proposes expanding the sales tax base to include:

- Additional prepared foods by broadening definitions of candy, soft drinks, snacks, desserts, etc.
- Amusement and recreational services such as movies, concerts, health and fitness centers, sports, dancing, amusement parks, historical sites, exhibitions, etc.
- Repair and maintenance services such as labor charges for installation, repair, or maintenance of tangible personal property and sales of extended service contracts, but excluding vehicular repairs.

1 William McBride, *What Is the Evidence on Taxes and Growth?*, Tax Foundation Special Report No. 207 (Dec.18, 2012), http://taxfoundation.org/article/what-evidence-taxes-and-growth.
2 Scott Drenkard, *The Two Hardest (But Most Important) Sales Tax Reforms*, Tax Foundation Tax Policy Blog, Aug. 2, 2012, http://taxfoundation.org/blog/two-hardest-most-important-sales-tax-reforms.

- Personal services such as barbers and beauty salons, cosmetic procedures, event planning, dating services, travel agencies, etc.
- Personal property services such as dry cleaning, laundry, car washes, pet services, furniture cleaning, personal chefs, warehousing and storage, moving services, etc.
- Household services like landscaping, home decorating and cleaning, pest control, swimming pool maintenance, home security systems, garbage removal, etc.
- Professional services such as legal services, accounting, bookkeeping, architecture, engineering, photography, financial planning, etc.
- Miscellaneous items like cable/satellite service and consumer long-distance calling.

In all cases, the governor's plan purports to exclude business inputs. The plan also proposes changes to the way that rental property is taxed. Currently, rentals of automobiles, campers, and motor homes are subject to sales tax on the rental stream, while other rental property is subject to a use tax on the cost of the property. The LePage plan would move the point of taxation to the rental stream for all taxable rentals. Similarly, there are currently two sales tax models for vending, which Governor LePage proposes to simplify by folding all vending sales into the general sales tax.

Discounts and Credits

Although the expansion to services makes the sales tax more progressive on the whole, since the consumption of consumer services is more concentrated in higher income brackets, the LePage plan includes a refundable sales tax credit to offset any regressivity introduced by the higher rates. The proposal envisions a refundable tax credit based on the number of tax exemptions claimed, which is phased out above certain income thresholds to limit applicability to low-income families (see Figure 3).

Figure 3. Proposed Refundable Sales Tax Credit

Exemptions	Base Credit
1	$250
2	$350
3	$400
4	$450
5	$475
6+	$500

Above the designated income threshold, the credit is reduced by specific dollar amounts for each additional income increment, as follows:

Filing Status	Credit reduced by...	for every...	above...
Single	$10	$500	$15,000
Head of Household	$15	$750	$22,500
Joint Filers	$20	$1,000	$30,000

LePage's plan also includes a retailer discount of the lesser of 0.5 percent or $1,000 per period, which retailers can deduct to cover the expense of reporting and collecting the sales and use tax. Small sellers—those whose gross sales do not exceed $3,000 per year—will be exempted from reporting and collecting sales taxes.

Property Taxes

Proposed real and personal property tax reforms would improve the state's ranking from 40th to 35th on property taxes in our *Index*.

Estate Taxes

The LePage plan phases out and ultimately repeals the estate tax, raising the exemption from $2 million to $5.5 million in 2016 and repealing the tax entirely for deaths on or after January 1, 2017. This change would follow the trend of many states turning away from death taxes in recent years.[3]

Real Property

The LePage plan proposes the doubling of the homestead exemption (to $20,000) for senior citizens and its elimination for taxpayers under age 65. It also halves the current 100 percent exemption above a $500,000 exemption for the real property of nonprofit organizations, with the exception of houses of worship, the property of which would remain fully tax-exempt. The proposed reduction in the exemption percentage is expected to generate at least $60 million in annual revenue to localities, modestly offsetting a proposed phase-out of state revenue sharing with localities, which will have a local impact of more than $164 million a year by the FY 2018–2019 biennium.

Most states do not levy property taxes on nonprofit organizations, though some are increasingly turning to negotiated payments in lieu of taxes for certain nonprofits.[4] There is, moreover, no uniformity on the subject: Virginia allows localities to decide whether to impose property taxes on nonprofits,[5] while the District of Columbia restricts the exemption to nonprofits focused on public charity principally in the District.[6]

The LePage plan also makes modifications to the Property Tax Fairness Credit, which caps property taxes for low-income and middle-income families. The plans would make more property owners eligible for relief, though the amount at which property taxes are capped will be higher, as seen in Table 4.

3 Liz Emanuel, Scott Drenkard, & Richard Borean, *State Estate and Inheritance Taxes in 2014*, Tax Foundation Tax Policy Blog, May 28, 2014, http://taxfoundation.org/blog/state-estate-and-inheritance-taxes-2014.

4 *See generally* Daphne A. Kenyon & Adam H. Langley, *Payments in Lieu of Taxes: Balancing Municipal and Nonprofit Interests* (2010), http://www.lincolninst.edu/subcenters/significant-features-property-tax/upload/sources/ContentPages/documents/PILOTs%20PFR%20final.pdf.

5 Daphne Kenyon & Adam Langley, *The Property Tax Exemption for Nonprofits and Revenue Implications for Cities* (Nov. 2011)at 8, http://www.urban.org/uploadedpdf/412460-property-tax-exemption-nonprofits.pdf.

6 D.C. Office of Tax and Revenue, *Exemption from D.C. Real Property Tax*, Jan. 1, 2013, http://otr.cfo.dc.gov/publication/exemption-dc-real-property-tax.

Table 4. Maine Property Tax Caps (current law and proposed changes)

	Current Law		**LePage Proposal**	
	Maximum Income	Property Tax Cap	Maximum Income	Property Tax Cap
Single Filers	$33,300	$2,000	$50,000	$3,000
Joint/HOH (0–2 exemptions)	$43,000	$2,600	$66,666	$4,000
Joint/HOH (3+ exemptions)	$53,300	$3,200	$83,333	$5,000

Personal Property

Historically, Maine allowed localities to tax business personal property but then reimbursed businesses for it at the state level through the Business Equipment Tax Reimbursement (BETR) program. Later, the state sought to streamline the process for business taxpayers by exempting business personal property from local taxation but reimbursing localities for 50 percent of the amount of personal property tax revenues they otherwise could have collected through the Business Equipment Tax Exemption (BETE) program. Although the state now only enrolls new retail businesses in the older BETR program, all property placed into service prior to April 2008 continues to be eligible under that program's terms.

The LePage plan accomplishes the consolidation of BETR into the BETE program over a four year period. All property currently in the BETR program will be eligible for a 25 percent exemption under the BETE program beginning in April 2016, a 50 percent exemption in 2017, a 75 percent exemption in 2018, and fully exempt for April 2019 and thereafter.

Going forward, non-retail property would continue to receive a full exemption under BETE, while retail property transferred into BETE from BETR will receive ten years of eligibility. New retail property would not be accepted into the BETE program.

Other Components

In addition to these reforms to individual and corporate income, sales, and property taxes, the LePage plan adopts several other revisions to tax policy and spending limitations, including

- Eliminating the state-level telecommunications excise, which raises an estimated $9 million per year, making telecommunications subject to taxation at the municipal level,
- Adjusting existing spending limitations to restrict the growth in annual appropriations to a the ten-year average of annual economic growth, eliminating the additional population growth factor and existing allowances for certain growth outside the cap, and
- A two-year phase-out of revenue sharing with localities—presently 5 percent of sales (general and service provider) and income (individual and corporate) tax collections—which was projected to net localities over $156 million per year over the coming biennium, and which would be reduced to $62.5 million in FY 2016 and repealed outright as of FY 2017.

Assessment

Governor LePage's proposal is both comprehensive and well thought out, reducing tax burdens and holding the potential to trigger a substantial improvement to the state's business climate.

Estimates from the governor's office suggest that by the FY 2018–2019 biennium, the plan would offer a state tax cut of $250 million per year, which would reduce state revenues by about $86 million per year and—including offsetting revenues from property tax base expansion—curtail local government revenues by approximately $100 million. Impacts would be significantly more modest in the first biennium, during the early stages of the phase-in.

If adopted in full, the governor's plan would improve Maine's ranking on our *State Business Tax Climate Index* from 33rd to 23rd, with improvements on subcomponents as follows:

Component	Current Law	LePage Proposal
Overall	**33**	**23**
Corporate	45	17
Individual	22	20
Sales	9	20
Unemployment Insurance	42	42
Property	40	35

Potential Improvements

The LePage proposal makes notable strides in the area of corporate tax reform, but Maine could improve its score still further by adopting a net operating loss (NOL) carryback provision. Eighteen of the 45 states with corporate income taxes allow NOL carrybacks of two to three years, permitting businesses suffering losses in a given calendar year to deduct those losses against prior years' tax returns. The federal government allows twenty years of NOL carryforwards and two years of NOL carrybacks.[7]

Net operating loss deductions are important for businesses with volatile revenues across the business cycle, ensuring that the tax code is more neutral with respect to time. Adopting an uncapped three-year carryback would be a modest change with a substantial impact on the state's business climate. In concert with the LePage proposal, this change would bump Maine up to 21st overall, with the state improving to the 4th best corporate component score.

Still, Governor LePage deserves credit for unveiling a proposal of this scope. The ball is now in the legislature's court. 2015 might be the year that Maine delivers on meaningful structural improvements of its tax system.

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7 Scott Drenkard & Joe Henchman, *2015 State Business Tax Climate Index* (Oct. 28, 2014), at 57, http://taxfoundation.org/sites/taxfoundation.org/files/docs/TaxFoundation_2015_SBTCI.pdf.