

**STATE OF MAINE
118TH LEGISLATURE**

**Final Report
of the**

**SPECIAL COMMISSION ON
FINANCIAL SERVICES TAXATION**

December 1998

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**Special Commission on Financial Services Taxation
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EXECUTIVE SUMMARY

In response to the deregulation and convergence of the financial services industry at the state and national level, the Legislature established the Special Commission on Financial Services Taxation (Commission) to address whether or not the changes in the types of financial services offered to consumers by banks, insurance companies, securities firms, mutual fund businesses and other competitors require changes in the way in which these businesses are taxed by the State. The Special Commission on Financial Services Taxation was established on July 31, 1998 by order of the

President of the Senate and the Speaker of the House of Representatives. Three Senate members and seven House members who serve on the Joint Standing Committee on Taxation, the Joint Standing Committee on Banking and Insurance or the Joint Standing Committee on Business and Economic Development were appointed to the Commission. The Commission was chaired by Senator Lloyd LaFountain III and Representative Bonnie Green.

The Commission was charged with reviewing Maine's tax laws applicable to entities that provide financial services in this State and making recommendations to ensure that Maine's tax structure is fair and equitable and to ensure that the State is competitive with other states in attracting and maintaining financial services businesses.

The Commission coordinated its efforts with a task force appointed by Governor Angus S. King, Jr. called the Financial Services Taxation Advisory Group (Advisory Group). Members of the Advisory Group included the State Tax Assessor who chaired the group; the Commissioner of Professional and Financial Regulation; representatives of the banking, insurance and investment industries and other providers of financial services; representatives of the legal and accounting professions; and representatives of the general public. Like the Commission, the Financial Services Taxation Advisory Group was asked to undertake a review of Maine's tax laws applicable to the financial services industry and to make recommendations to ensure that Maine's tax structure is fair, equitable and competitive with other states in attracting and maintaining financial services businesses.

The Commission was convened on August 12 and met a total of five times to complete its work. Three meetings were held in conjunction with the Financial Services Taxation Advisory Group.

The Commission and the Advisory Group decided to focus on specific areas where changes to the tax laws could make an impact on the inequities in the taxation of participants in the financial services industry. The areas of focus for discussion were:

- The structure of Maine's tax laws based on functionality and the definition of financial services for the purposes of the franchise tax on financial institutions;
- Increased authority for Maine Revenue Services to determine the allocation of income and assets for financial services entities modeled on Section 482 of the Internal Revenue Code;
- Expansion of nexus under the franchise tax and corporate income tax;
- Additional tax credits for insurance companies subject to the premium tax; and
- The use of tax incentives to promote economic development of the financial services industry in the State.

The Special Commission makes the following findings and recommendations. It is the understanding of the Commission that the Financial Services Taxation Advisory Group endorses the recommendations made by the Commission.

RECOMMENDATION 1. The commission recommends that Maine Revenue Services be directed to monitor State revenues from the taxation of financial services and report annually to the Legislature on any changes in revenue in the bank franchise tax, insurance premium tax or corporate income tax directly or indirectly resulting from the expansion of financial services entities into non-traditional lines of business; any issues and trends resulting from the expansion of traditional financial services entities into insurance sales and underwriting, sales of securities and mutual funds, investment banking and other types of financial

services; and any activities of other states and the Multistate Tax Commission related to the taxation of financial services

RECOMMENDATION 2. The commission recommends that Maine Revenue Services monitor legal developments relating to the definition of “nexus” for purposes of the franchise tax on financial institutions and the corporate income tax. The commission requests the State Tax Assessor to encourage the Multistate Tax Commission to work expeditiously on developing strategies for states to address the changing nature of the financial services industry in a fair and uniform manner that reduces the potential for double taxation of taxpayers doing business in more than one state.

RECOMMENDATION 3. The commission recommends that the Joint Standing Committee on Business and Economic Development and the Joint Standing Committee on Taxation work together to develop strategies for attracting financial services businesses to Maine.

I. INTRODUCTION

In today’s economy, the traditional “firewall” between the banking, insurance and securities industries has started to break down. Banks sell insurance, annuities and securities in addition to their traditional deposit and loan services. Other competitors in the financial services industry also offer mortgages, credit cards, loans and other consumer credit products that were once the domain of banks. Insurance companies sell annuities tied to investments in mutual funds and other securities. Securities brokerage firms offer checking and credit card services to their customers. In response to these changes in the financial services industry at the state and national level, the Legislature established the Special Commission on Financial Services Taxation (Commission) to address whether or not the changes in the types of financial services offered to consumers by banks, insurance companies, securities firms, mutual fund businesses and other competitors require changes in the way in which these businesses are taxed by the State.

The Special Commission on Financial Services Taxation was established on July 31, 1998 by order of the President of the Senate and the Speaker of the House of Representatives. Three Senate members and seven House members who serve on the Joint Standing Committee on Taxation, the Joint Standing Committee on Banking and Insurance or the Joint Standing Committee on Business and Economic Development were appointed to the Commission. The Commission was chaired by Senator Lloyd LaFountain III and Representative Bonnie Green. The Order establishing the Commission is included as Appendix A.

The Commission was charged with reviewing Maine’s tax laws applicable to entities that provide financial services in this State and making recommendations to ensure that Maine’s tax structure is fair and equitable and to ensure that the State is competitive with other states in attracting and maintaining financial services businesses.

II. COMMISSION PROCESS

The Commission coordinated its efforts with a task force appointed by Governor Angus S. King, Jr.

called the Financial Services Taxation Advisory Group (Advisory Group). The Financial Services Taxation Advisory Group was created by Executive Order No. 3 FY 97/98 on May 27, 1998. Members of the Advisory Group included the State Tax Assessor who chaired the group; the Commissioner of Professional and Financial Regulation; representatives of the banking, insurance and investment industries and other providers of financial services; representatives of the legal and accounting professions; and representatives of the general public.

Like the Commission, the Financial Services Taxation Advisory Group was asked to undertake a review of Maine's tax laws applicable to the financial services industry and to make recommendations to ensure that Maine's tax structure is fair, equitable and competitive with other states in attracting and maintaining financial services businesses.

The Commission met five times on August 12, September 1, September 29, November 23 and December 11 to complete its work. The meetings on September 1, September 29 and November 23 were held in conjunction with the Financial Services Taxation Advisory Group. A portion of the meeting on November 23rd was set aside to receive public comment on the proposed findings and recommendations of the Commission and the Advisory Group. The meeting on December 11 focused on the Commission's discussion of its draft report and recommendations.

It is the understanding of the Commission that the Financial Services Taxation Advisory Group endorses the recommendations made by the Commission.

In addition to the input of the Financial Services Taxation Advisory Group, the Commission was assisted by staff of the Office of Fiscal and Program Review, the Office of Policy and Legal Analysis and Maine Revenue Services.

III. CURRENT TAXATION OF FINANCIAL SERVICES IN MAINE

The first step undertaken by the Commission was to study the provisions of current Maine law relating to the taxation of financial services.

The taxation of the various segments of the financial services industry reflects the development of those methods of taxation in different historical periods. Insurance, banking and other financial services are each subject to a different form of taxation. The tax structure reflects the history of these activities and the separate regulatory systems that, until recently, kept them very separate entities. In recent years, with the deregulation of banking, businesses that were traditionally restricted to one field have reached out to provide services that they were formerly prohibited from entering. The tax structure, by defining taxable activities based upon the regulatory identity of the business performing the activity, has failed to keep pace with the increasing convergence of financial services businesses flowing from deregulation. Maine law provides one form of taxation for insurance companies and another form of taxation for financial institutions. Financial services that do not fall into one of these categories are taxed under the general income tax.

A. TAXATION OF INSURANCE COMPANIES

History. The activity of selling insurance in the State was identified as a desirable source for State revenue more than a century ago. The first tax on insurance companies was enacted in 1874 as a 2% tax on premiums reduced by claims. The tax has been imposed on gross direct premiums for the last

50 years, originally at the rate of 1% for domestic insurers and 2% for foreign companies. In 1986 the law was amended to provide for a 2% rate on both foreign and domestic insurers.

Current Maine Insurance Premium Tax. The insurance premium tax is imposed instead of the state income tax.

Companies subject to the tax. The insurance premium tax applies to the following companies:

- Insurance companies that do business or collect premiums in Maine, including credit or title insurance
- Risk retention groups
- Surplus lines brokers
- Captive insurance companies
- Workers' compensation insurance companies

Tax base: Taxes are imposed on gross direct premiums on contracts written on risks located or resident in Maine

Rate of tax: The rate of tax varies depending on the type of policy. The following rates apply.

- The general rate is 2% of gross direct premiums including annuities
- 1% on long-term care insurance policies
- 1%/2.55% on qualified group disability policies
- Varying amounts on captive insurance companies
- Retaliatory rates are applied to foreign insurance companies in the amount that their home states impose on Maine companies, if those rates are higher than Maine's rates

Credits: The following are allowed as credits under the insurance premium tax:

- Employer-assisted day care
- Employer-provided long-term care benefits
- Solid waste reduction investment tax credit

B. TAXATION OF FINANCIAL INSTITUTIONS

History. Until 1986, banks were taxed in the same way as corporations under the corporate income tax. In 1983, a United States Supreme Court decision ruled unconstitutional a tax scheme similar to Maine's because it exempted income from state and local obligations but not federal obligations. In 1984, the current franchise tax on financial institutions was enacted to replace the questionable tax.

Current Taxation Of Financial Institutions. The franchise tax on financial institutions is imposed instead of the state income tax.

Companies subject to the tax. The franchise tax on financial institutions applies to the following companies:

- Financial institutions authorized to do business in this state
- Banks including savings banks, industrial banks, savings and loan associations, other entities that accept deposits that are federally insured
- Bank holding companies and savings and loan holding companies
- A corporation with more than 50% of its stock owned directly or indirectly by an entity or entities subject to the tax
- It does not include credit unions

Tax base: The franchise tax on financial institutions has two components. The first component calculates a portion of the tax as an assessment against Maine net income. The second component calculates a portion of the tax as assessment against Maine assets.

Rate of tax:

- 1% of Maine net income
- 8 cents per \$1,000 of Maine assets

Credits: Financial institutions are entitled to the same credits as taxpayers under the corporate income tax, although some of the credits may not be applicable to financial institutions. (See listing under paragraph C)

C. TAXATION OF OTHER FINANCIAL SERVICES ACTIVITIES

Other activities in the financial services industry that were considered by the Commission included securities and investment firms and lenders not connected with financial institutions. These business do not fit under the insurance premium tax nor the financial institution franchise tax unless they are owned by an entity that is subject to those taxes. They are covered by the provisions of the state income tax. Corporations are subject to the corporate income tax. Other entities are treated for income tax purposes in the same way as they would be treated under the federal income tax.

History. The corporate income tax was adopted in 1969 with a flat rate of 4% of Maine net income. While the rates of tax have been changed several times and numerous credits against the tax have been added and repealed, the basic structure of the tax remains the same.

Companies subject to the tax. The corporate income tax is imposed on any corporation, other than those subject to the insurance premium tax or the financial institution franchise tax, that has federal taxable income as modified by Maine law and apportioned to Maine.

Tax base: The tax is imposed on “Maine net income” which is federal taxable income as modified by Maine law to reflect the addition and subtraction of items of income that are treated differently under Maine law than under federal law. For corporations that do business in more than one state, taxable income is apportioned to Maine through the Uniform Division of Income for Tax Purposes Act (UDITPA) based on the proportion of the business’ property, payroll and sales in Maine, with the sales factor double counted.

Rate of tax: The corporate tax has four graduated rates:

If the taxable income is: The tax rate is:

- \$0 but not over \$ 25,000 3.5%
- \$ 25,000 but not over \$ 75,000 7.93%
- \$ 75,000 but not over \$250,000 8.33%
- \$ 250,000 or over 8.93%

Credits: The following credits are available to taxpayers under the corporate income tax:

- Jobs and investment tax credit
- Seed capital investment tax credit
- Employer-assisted day care credit
- Credit for taxes paid to another taxing jurisdiction
- Solid waste reduction investment tax credit
- Investment tax credit
- Research expense credit
- Super credit for substantially increased research and development
- High-technology investment tax credit
- Credit for dependent health benefits paid
- Clean fuel vehicle economic and infrastructure development credit

IV. AREAS OF FOCUS

The Commission and the Advisory Group decided to focus on specific areas where changes to the tax laws could make an impact on the inequities in the taxation of participants in the financial services industry. The areas of focus for discussion were:

- The structure of Maine's tax laws based on functionality and the definition of financial services for the purposes of the franchise tax on financial institutions;
- Increased authority for Maine Revenue Services to determine the allocation of income and assets for financial services entities modeled on Section 482 of the Internal Revenue Code;
- Expansion of nexus under the franchise tax and corporate income tax;
- Additional tax credits for insurance companies subject to the premium tax; and
- The use of tax incentives to promote economic development of the financial services industry in the State.

A. Functionality

As the financial services industry has evolved, banks and other financial institutions have started providing insurance, investment and other products and services that were traditionally offered by non-banks. Maine's tax structure is based on the way businesses are organized and regulated rather than on the basis of the services provided. The blurring of the lines between product offerings of different entities has also raised questions about the application of the tax laws to these entities. It was recognized by the Commission that a strict application of the current tax law to banks and financial institutions selling insurance and securities resulted in a disparity in the tax treatment between market competitors. For example, an insurance agency owned by a bank is currently subject to the bank franchise tax and an independently owned insurance agency is subject to the

state income tax. To address this apparent inequity, the Commission explored a “functional approach” to taxation of sales of insurance which would separate the insurance sales function of a bank so that the same rate of taxation could be applied to insurance sales regardless of the ownership of the agency. A similar approach could also be used for the taxation of other activities, like the sale of securities by a bank, that traditionally were not regarded as the business of banking.

An important component of a functional approach to the taxation of activities undertaken by banks, insurance companies, securities and investment companies and other financial services entities is the definition of a financial institution. Only those entities that meet the definition of “financial institution” are subject to the franchise tax. Any discussion of functional changes in the tax treatment of financial institutions must also take into account the definition of financial institution and those activities that are permissible for a financial institution to perform.

B. Maine Revenue Services authority to allocate income and costs

In exploring the issue of functionality, the Commission recognized that additional authority for Maine Revenue Services may be necessary to enable the State to administer and enforce any changes based on function in taxation as applied to financial institutions. In particular, the Commission discussed providing Maine Revenue Services with statutory authority in Maine’s tax laws modeled on Section 482 of the Internal Revenue Code to determine the allocation of income and assets for financial services entities. Under Section 482, the Internal Revenue Service (IRS) has the authority to “distribute, apportion or allocate gross income, deductions, credits or allowances” between two or more businesses owned or controlled directly or indirectly by the same interests to prevent tax evasion or to clearly reflect the income of such businesses. This authority was viewed as especially important by staff of Maine Revenue Services if a functional approach to taxation of financial institutions selling insurance or securities were adopted.

C. Nexus

“Nexus” is a legal concept that refers to the degree of connection that a state must have with an entity in order to be able to tax that entity. Nexus is defined by the United States Supreme Court analysis of the application of the Due Process Clause and the Commerce Clause of the United States Constitution to state tax laws. While it is clear that nexus is required for a state to tax an entity, the law is not always clear what kind of connection constitutes adequate nexus. For purposes of sales tax, the nexus requires that the entity have some “substantial physical presence” in the taxing state. (*Quill v. North Dakota*, 504 U.S. 298 (1992)) For income tax or the franchise tax on financial institutions, it is not clear whether physical presence is required.

Amidst this legal quagmire, several states have adopted nexus standards based on economic presence of a business in the state. These statutes typically require some minimum volume of business in the state, usually determined by number of customers in the state or the dollar value of the business conducted.

Maine franchise tax law currently requires “substantial physical presence” in Maine for

application of the tax. Maine corporate income tax law does not specify a standard; however, rules of Maine Revenue Services state that the state asserts taxing authority to the "... full extent permitted by the Constitution and the laws of the United States."

With regard to nexus, the Commission recognized that there may be instances where financial services entities are doing business in the State without any physical presence here. These companies are not paying taxes in Maine on the companies' Maine-based income or activities and may not be paying taxes in any state on Maine-based income. The Commission explored the issue of nexus as it applied to the taxation of out-of-state companies doing business in Maine that compete against Maine-based financial entities.

D. Tax Credits For Insurance Companies

Another issue discussed by the Commission was whether or not to adopt additional tax credits for insurance companies subject to the insurance premium tax. The issue arose during the consideration and analysis of the bank franchise tax, the corporate income tax and the insurance premium tax. The Commission discussed the possibility of expanding the tax credits available to insurance companies to include all of those tax credits available to financial institutions under the franchise tax and corporations under the corporate income tax.

E. Tax Incentives To Promote Economic Development Of The Financial Services Industry

The Commission was specifically charged with addressing the issue of whether or not the State is competitive with other states in attracting and maintaining financial services businesses. On this issue, the Commission discussed the use of tax incentives to promote and encourage economic development of the financial services industry. The financial services industry was identified as a growth industry with high quality jobs that can be located anywhere. Many believe Maine can compete effectively with other states on a physical basis because of its telecommunications infrastructure, skilled and productive work force and quality of life. Tax incentives are viewed as an additional factor that can be used to attract businesses in the financial services industry.

V. RECOMMENDATIONS

The Special Commission makes the following findings and recommendations.

RECOMMENDATION 1. The commission recommends that Maine Revenue Services be directed to monitor State revenues from the taxation of financial services and report annually to the Legislature on any changes in revenue in the bank franchise tax, insurance premium tax or corporate income tax directly or indirectly resulting from the expansion of financial services entities into non-traditional lines of business; any issues and trends resulting from the expansion of traditional financial services entities into insurance sales and underwriting, sales of securities and mutual funds, investment banking and other types of financial services; and any significant activities of other states and the Multistate Tax Commission related to the taxation of financial services

With deregulation and convergence of financial services activities, financial institutions are taking on functions that have traditionally been organized and taxed under the insurance premium tax or corporate income tax laws. To the extent that those functions become taxed under the franchise tax rather than the insurance premium tax or the corporate income tax, the tax paid may be lower than for services provided and taxed in the traditional way. For example, an insurance agency owned by a bank is currently subject to the bank franchise tax and an independently owned insurance agency is subject to the state income tax. Similarly, banks that purchase securities brokerages would pay a franchise tax while securities brokerages not owned by banks would pay corporate income tax.

The extent to which the taxation of financial services may be “migrating” from the insurance premium tax or the corporate income tax to the franchise tax and the resulting loss of revenue, if any, is not clear. The Commission recommends that Maine Revenue Services be directed to monitor and identify any changes in revenue attributable to deregulation and convergence of financial services. Maine Revenue Services should be required to report on an annual basis beginning in January 1999 for the 1998 tax year and for each subsequent tax year to the Joint Standing Committees on Appropriations and Financial Affairs, Taxation and Banking and Insurance. The reports should identify any changes in revenue related to the taxation of financial services; any issues and trends resulting from the expansion of traditional financial services entities into insurance sales and underwriting, sales of securities and mutual funds, investment banking and other types of financial services; and any activities of other states and the Multistate Tax Commission related to the taxation of financial services.

Rather than recommend passage of a separate piece of legislation, the Commission recommends that the Joint Standing Committee on Taxation incorporate the reporting requirement outlined above as an amendment to related legislation before the committee or as a committee bill in the First Regular Session of the 119th Legislature.

RECOMMENDATION 2. The commission recommends that Maine Revenue Services monitor legal developments relating to the definition of “nexus” for purposes of the franchise tax on financial institutions and the corporate income tax. The commission requests the State Tax Assessor to encourage the Multistate Tax Commission to work expeditiously on developing strategies for states to address the changing nature of the financial services industry in a fair and uniform manner that reduces the potential for double taxation of taxpayers doing business in more than one state.

The commission considered recommending expanding state taxing authority over financial institutions with economic presence in Maine that do not currently pay tax because they do not meet the “substantial physical presence” test. After thorough consideration, the commission decided that now is not the proper time to make changes in the nexus standards currently in Maine law. The financial services industry is evolving rapidly. Changes made today, might not only have a negative impact on business decisions regarding whether to do business in Maine; they could also turn out to be the wrong choices for the long run.

Maine is a member of the Multistate Tax Compact. This compact is administered by the Multistate Tax Commission that “...acts to protect state tax authority from unwarranted federal intervention, supports the growth of commerce by improving the administrative efficiency and marketplace equity of state business tax systems and encourages voluntary uniformity in multistage tax policies.” Maine’s

participation in the compact results from a decision on the part of policy makers to keep Maine in the mainstream of tax administration and to avoid competition with other states by means of tax policy.

The commission was informed that the Multistage Tax Commission has begun to consider the challenges presented by changes in the financial services arena. The commission concluded that it would be in the best interests of Maine to defer any changes to nexus standards until the Multistage Tax Commission has had the opportunity to study and make recommendations regarding the taxation of multistage financial services. The commission requests that the State Tax Assessor encourage the Multistage Tax Commission to conclude its consideration expeditiously and that, at the conclusion of that consideration, the State Tax Assessor present legislation consistent with the recommendations of the Multistage Tax Commission relating to the taxation of financial services.

RECOMMENDATION 3. The commission recommends that the Joint Standing Committee on Business and Economic Development and the Joint Standing Committee on Taxation work together to develop strategies for attracting financial services businesses to Maine.

The commission recognizes that the financial services industry is a desirable industry to attract to Maine. The industry has been identified as generally offering higher than average wages and having low environmental impact. Financial services industries frequently rely heavily on telecommunications infrastructure which Maine can offer competitively with more traditionally located states. Technological advances permit the location of financial services businesses far from the traditional centers of financial activity. Maine would benefit from the location of financial services businesses in the State, and policy administrators should pursue this goal.

Appendix A:
Order of the Presiding Officers Establishing the
Special Commission on Financial Services Taxation