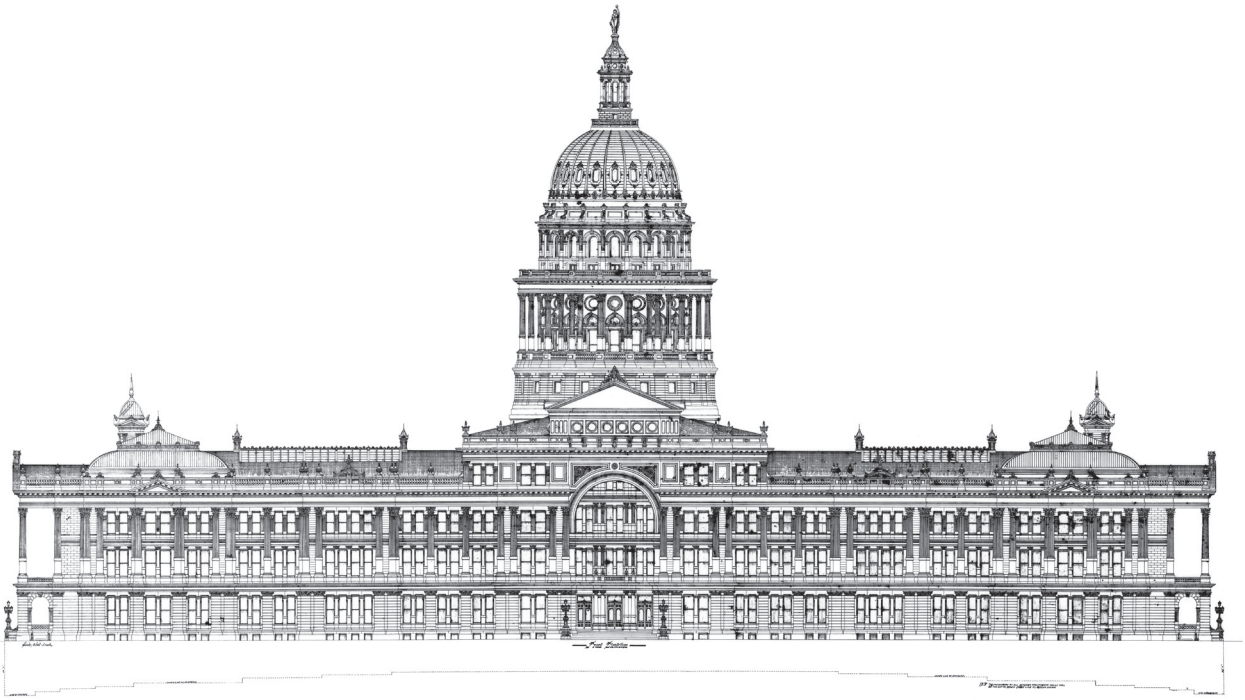
Interim Report

to the 82nd Texas Legislature

House Committee on

Ways & Means

January 2011



HOUSE COMMITTEE ON WAYS & MEANS
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2010

A REPORT TO THE
HOUSE OF REPRESENTATIVES
82ND TEXAS LEGISLATURE

RENÉ OLIVEIRA
CHAIRMAN

COMMITTEE CLERK
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House Committee On Ways & Means

January 10, 2011

Rene Oliveira, Chairman
P.O. Box 2910
Austin, Texas 78768-2910

The Honorable Joe Straus
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on Ways & Means of the Eighty-first Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Eighty-second Legislature.

Respectfully submitted,

Rene Oliveira

Rep. John Otto, Vice Chair

Rep. Dwayne Bohac

Rep. Will Hartnett

Rep. Harvey Hilderbran

Rep. Charlie Howard

Rep. Phil King

Rep. Ken Paxton

Rep. Aaron Peña

Rep. Larry Taylor

Rep. Mike Villarreal

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INTRODUCTION

At the beginning of the 81st Legislature, the Honorable Joe Straus, Speaker of the Texas House of Representatives, appointed eleven members to the House Committee on Ways & Means (the Committee). The Committee membership included the following appointees: René Oliveira, Chair, John Otto, Vice Chair, Dwayne Bohac, Will Hartnett, Harvey Hilderbran, Charlie Howard, Phil King, Ken Paxton, Aaron Peña, Larry Taylor and Mike Villarreal.

During the interim, Speaker Straus assigned the Committee on Ways & Means the following charges:

> Monitor the revised franchise tax and identify changes to simplify the tax and improve compliance and fairness.
>
> Examine the state's major tax exemptions to determine how the current costs and benefits compare with the original legislative objectives. Make recommendations for adjustments as needed.
>
> Study methods for improving the quality and uniformity of, and communications to taxpayers about, property tax appraisals.
>
> Evaluate the impact of the transfer of administrative law judges from the Comptroller's Office to the State Office of Administrative Hearings on the dispute resolution process.
>
> Study the tax structure as applied to cable versus satellite service to determine if any unfair competition results from state tax policies.
>
> Monitor the implementation of property tax appraisal and alternative valuation appeal reforms enacted by the 81st Legislature.
>
> Monitor the agencies and programs under the committee's jurisdiction.

The Committee met in seven public hearings, held January 13, 2010, February 10, 2010, March 25, 2010, April 20, 2010, May 25, 2010, August 17, 2010, and October 14, 2010. The Committee also accepted written testimony and research from the public in the course of compiling this report. Appreciation is extended to those who testified before the Committee and those that submitted written materials during this time. A special appreciation is extended to all the agency personal that assisted the Committee during this process especially the staff from the Texas Comptroller's Office of Public Accounts.

HOUSE COMMITTEE ON WAYS & MEANS

INTERIM STUDY CHARGES

CHARGE Monitor the revised franchise tax and identify changes to simply the tax and improve compliance and fairness.

CHARGE Examine the state's major tax exemptions to determine how the current costs and benefits compare with the original legislative objectives. Make recommendations for adjustments as needed.

CHARGE Study methods for improving the quality and uniformity of, and communications to taxpayers about, property tax appraisals.

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CHARGE Study the tax structure as applied to cable versus satellite service to determine if any unfair competition results from state tax policies.

CHARGE Monitor the implementation of property tax appraisal and alternative valuation appeal reforms enacted by the 81st Legislature.

CHARGE Monitor the agencies and programs under the committee's jurisdiction.

Charge 1

Monitor the revised franchise tax and identify changes to simplify the tax and improve compliance and fairness.

Background

The impetus for the legislature to reform the franchise tax was brought on by the Texas Supreme Court's decision that the state's property tax system had become a *defacto* statewide property tax because many school districts did not have "meaningful discretion" because had hit the tax rate cap at the time of $1.50 per $100 of value. The tax rate was essentially required by the constitutional education requirements. Revising the funding required a change to the state's franchise tax.

The goals of the revised tax were to reform the state's business tax structure, to spread the tax burden more equally across all taxpayers, and to capture some businesses that were avoiding the tax. An additional goal of the tax revision was to increase states' portion of public education funding, and provide a reduction (33 percent) in school property taxes.

In 2006, the Texas Legislature revised the state's franchise tax to base the tax on gross margins. Governor Perry signed the original law on May 18, 2006, and the first taxable period began on January 1, 2007, with the first returns coming due in May 2008. In an effort to provide greater fairness, the revised franchise closed many of the exemptions that existed so that more businesses paid the tax. By broadening the application of the tax, the legislature was able to reduce the rate from 4.5 percent to either .5 percent or 1 percent.

Another significant change allowed businesses with total revenue of less than $300,000 an exemption from the tax. In 2007, the Legislature added a sliding scale of franchise tax discounts implemented for businesses with revenue between $300,000 and $900,000. The intention was to save small businesses from the administrative burden of filing small returns. During this past legislative session, House Bill 4765 was passed to assist small businesses during the recent economic down turn. The exemption was raised from $300,000 to $1 million for the following two years, then falling to $600,000 in the years thereafter. The cost to the state for this change was $172 million over the biennium.[1]

The expectation was that the franchise tax would provide a reliable source of revenue for school districts. While the revised franchise tax is raising more revenue than the original franchise tax, it is not bringing in what was originally anticipated.[2] At the beginning of the 81st Legislature, estimates projected revenues at $3 billion short of anticipated revenues.

For FY 2010, the Comptroller's Office original estimate of revenue from the franchise tax was anticipated to be $6.4 billion; however actual revenue was $3.9 billion. The $2.5 billion gap between the two numbers is attributable in part, $1.0 billion, to the recession and $1.5 billion to underperformance of the tax compared to the original estimate.[3]

[1] Fiscal Note, HB 4765, 81R.
[2] Testimony by John Heleman, Chief Budget Revenue Estimator, Texas Comptroller's Office of Public Accounts, House Committee on Ways and Means, May 25, 2010.
[3] The Business Tax Advisory Committee, Report to the 82nd Legislature, Texas Comptroller's Office of Public Accounts, December 2010.

Implementation

The revised franchise tax base is calculated by deducting one of three amounts from the total revenue: cost of goods sold (COGS), compensation (including health insurance, pensions and other benefits), or a minimum deduction of 30% of revenue.

Although the tax is still relatively new, many taxpayers feel that there are problems with equity and compliance that need to be addressed. Critics point specifically to the inadequacy in the current definitions of cost of goods sold, eligibility for the compensation deduction, and what entities should be considered a wholesaler or retailer. Moreover, there are also concerns about the adequacy of the audits performed by the Comptroller's Office. Numerous bills were filed during the 81st Legislature that attempted to revise, amend, or completely do away with the new tax. However, the fiscal constraints at the time did not allow for many further changes. Therefore, the committee was charged with looking into issues of compliance and fairness during the interim in anticipation of any potential change.

Broadly, the areas in which issues are likely to continue to develop are: equity and fairness; administration and computation issues; and adequacy.

The Committee held hearings relating to these franchise tax issues and the following summarizes many of the issues and problems various business and industries brought to the Committee's attention.

Equity / Fairness / Administrative / Adequacy Issues

The recession has lessened franchise tax revenues considerably. Even if the recession had not hit, revenues would have been lower than originally projected, primarily because the Comptroller's Office overestimated which deductions businesses would use most. In all fairness, the Texas Franchise tax is unique and estimators did not have similarly performing taxes in other states on which to draw insight.

Cost of Goods Sold

After examining several factors that contributed to the reduced amount of franchise tax collections, the Comptroller's Office concluded a primary administrative reason for the variance is related to the Cost of Goods Sold deduction. The number of taxpayers that deducted COGS was higher than anticipated. Out of the $2 billion in revenue collected, the Comptroller's Office anticipated that 79% would deduct COGS instead of the 84% that actually deducted COGS. Also, the amount deducted by taxpayers was higher than expected.[4] The Comptroller's Office estimated 68.4% of all franchise tax deductions would come from COGS; the actual amount reached 82%.[5] With more taxpayers than anticipated deducting more money than anticipated revenues have fallen considerably short of original estimates.

[4] The Business Tax Advisory Committee, Report to the 82nd Legislature, Texas Comptroller's Office of Public Accounts, January 2011.
[5] Written and Oral Testimony, Mike Reissig, Texas Comptroller's Office's Office, August 17, 2010.

There are differences in definitions and purpose between federal COGS and Texas COGS worth noting. Federal COGS allows for the deduction of qualifying inventory costs when the goods are sold. Costs of unsold goods at the end of the year are in ending inventory and not deductible until a future year. The purpose of Texas COGS is to identify all qualifying costs that are deductible to compute margin. Any non-COGS costs not deducted are include in the taxpayer's margin. However, federal non-COGS are deductible on other lines of the federal return to calculate federal tax. Additionally, Texas COGS and federal COGS cannot be counted simultaneously or for each other. For example, COGS are not extended to all service businesses, specifically telecommunications, transportation and courier companies which are allowed under federal COGS.[6]

Section 171.1012(c), Tax Code defines COGs as "all direct costs of acquiring or producing the goods." The statute includes a laundry lists of specific costs permitted including: labor costs, costs of materials that are integral to production, costs of materials consumed in production, handling costs, storage costs, certain costs reported on the federal income tax return such as depreciation, depletion, and amortization, cost of renting/leasing or repairing/maintaining equipment, facilities, or real property, costs attributable to research, geological/geophysical costs, taxes paid in acquisition/production, cost of producing/acquiring electricity sold, and contribution to a partnership in which the taxable entity owns an interest used to fund activities. A taxable entity must sell tangible personal property or real property in the ordinary course of businesses in order to qualify for the COGs deduction.

The Committee received testimony from the Texas Taxpayers and Research Association (TTARA) stating that the original concept of cost of goods sold was rather simple if all it entailed was using a few numbers from a taxpayer's federal return. A lot of the definitions on the federal return allow for latitude on the part of the taxpayer. Taxpayers interpret the term "cost of goods sold" differently. Some taxpayers, when filing their federal returns, go through the difficult calculation of including items as a "cost of goods sold" whereas others simply expense the item and directly deduct them. The federal government does not tend to spend a significant time auditing this issue since their biggest concern is the bottom line number of profit. Therefore, cost of goods sold from a federal perspective is not a set number, so it would be challenging to try and tie the state cost of goods sold number by merely pulling it off the federal form. A better proposition would be to review and incorporate the actual federal definition instead of using just a number.[7]

TTARA also pointed out there are some gray areas in the current state definition. It stated that it was also worth noting that some of the items included in COGS were policy driven, where the state determined what it actually wanted to allow as a cost of goods sold. Additionally, using just the federal definition would not benefit every taxpayer. For example, some service companies in their federal tax returns have latitude in using costs of goods sold calculation where they might not be able to under the revised franchise tax. In other areas, industry such as oil and gas would not benefit since the federal definition is less comprehensive than the state definition.

[6] *Id.*

[7] Testimony by Dale Craymer, Texas Taxpayers and Research Association, House Committee on Ways and Means, August 17, 2010.

Therefore, it is difficult to make an across the board determination of who the winners and losers would be if the federal definition were incorporated for state franchise tax purposes.[8]

The Committee also received testimony from the Texas Society of CPAs, arguing that at a minimum the deduction would be streamlined if taxpayers could use the federal definition. They also agreed that it would be difficult to determine who the winners and losers if the federal definition was used since for some companies the compliance cost may be higher under the current definition, but ultimately the tax savings outweigh those costs. They did think that some of businesses would prefer to have a bifurcated system where the taxpayer could choose to use the definition that best fit their business model.[9]

In determining whether Texas should adopt the federal COGS definition total revenues should be considered. The Comptroller's Office testified that at this time no analysis has been done as to how this potential change would affect revenue for the franchise tax. They reiterated that the using the federal definition would help some taxpayers, but also hurt other taxpayers.[10]

The Committee received testimony from the Texas Apartment Association, ("TAA"). TAA states that rental properties are currently not allowed to take the cost of goods sold option for purposes of calculating taxable revenue. Instead, rental properties take the compensation deduction, which in their case is only 15 percent of total revenue, however they pay only 70 percent total revenue given 30 percent minimum deduction.

TAA argues that depreciation, which is a cost of goods sold under federal law, but not state, should be permitted under the franchise tax. TAA argues the change would better reflect economic realities. TAA states that the cost of goods sold definition is especially punitive in years when rental property is sold. Because rental property businesses are permitted to deduct depreciation from their federal tax forms on an annual basis, the federal government recaptures the deduction as capital gains in the year the property is sold. Because the revised franchise tax uses IRS capital gains information, the taxpayer pays not only on capital gains, but also on depreciation. TAA argues that when property is sold it pays a larger than equitable amount.

TAA suggests allowing their industry to take a deduction for the depreciation of rental property. They estimate that the fix would cost the state a loss of revenue around $19 million.[11]

Tax Rate

Under the revised franchise tax, taxpayers not using the E-Z calculation are subject to pay one of two rates. Businesses engaged in retail or wholesale trades qualify for the lower rate of .5 percent of the taxable margin. All other taxpayers pay a 1 percent rate.[12] In order to qualify as a

[8] *Id.*
[9] Testimony by Bob Owen, Texas Society of CPA's, House Committee on Ways and Means, August 17, 2010.
[10] Testimony, Mike Reissig, Texas Comptroller's Office, August 17, 2010.
[11] Testimony by Michele Gregg, Texas Apartment Association, House Committee on Ways and Means, May 25, 2010.
[12] §§171.102(a)-(c), Texas Tax Code.

retailer/wholesaler, the statute requires that at least 51 percent of its activities be related to retail and wholesale trade, unless a specific exemption from the requirement is provided.[13] The legislature allowed for the distinction because retailers/wholesalers operate at a lower margin of profit.[14]

Some businesses are a mix of retail/wholesale trades and perform services. The tax does not recognize that mix. Occasionally some industries that are very similar and in direct competition, competitors are taxed at different rates. For example, a tuxedo rental business that sells items such as ties, cuff-links, and belts is in direct competition with a men's suit store, however because the tuxedo store's primary business is renting tuxedos and not in retail it does meet the definition of retailer and is unable to pay the lower .5 percent on its taxable margin.

To determine who is a retailer, the franchise tax uses the federal Standard Industrial Classification Manual (SIC).[15] For example, a consumer purchasing the very same product, shampoo, can have distinct tax consequences depending on where it was purchased: if at a beauty salon the business is required to pay the 1 percent tax rate since it is not defined as a retailer: whereas a retail store is only required to pay the 1/2 percent tax rate.

The Texas Restaurant Association, (TRA) also took issue with current definition of retailer in determining the rate of taxation. TRA recognizes that although the franchise tax currently excludes from the higher rate of tax any retail business that sells more than 50% of the goods they manufacture, their industry does enjoy a specific exemption excluding restaurants from the higher rate. However, they point out that other business establishments such as bagel shops, donut shops, etc. must still pay the higher rate even though their business model is almost identical to that of a restaurant, because these types of businesses are defined by a different SIC code than restaurants. TRA argues the inequity that should be addressed. They recognize that any statutory change to include donut shops, bagel shops, and similar business needs to be narrowly tailored in order to ensure large scale bakeries, which are essentially manufacturers, are not included.[16]

The Texas Retailers Association ("Association") brought up two other issues that are also definition related. The Association pointed out that while retail businesses are entitled to .5 percent rate due to their SIC code definition there are a number of their members that operate much in the same manner as a retailer but because greater than 51% of their business comes from rental items, they are unable to take advantage of the .5 percent rate and instead are subject to the 1 percent rate. The Association argues that these rental businesses essentially operate as a retailer and thus should be entitled to the retailer rate. [17]

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[13] *Id.*

[14] Discussion by Ways and Means Committee Members, May 25, 2010.

[15] §171.102(c-1)/ the Standard Industrial Classification is a U.S. government system for classifying industries. It was established in 1937, and is published by the federal Office of Management and budget. It is being supplanted by the North American Industry Classification System, released in 1997; however certain government departments and agencies, still use the SIC codes.

[16] Testimony by Richie Jackson, Texas Restaurant Association, House Committee on Ways and Means, May 25, 2010.

[17] Testimony by Ronnie Volkening, Texas Retailers Association, House Committee on Ways and Means, May 25, 2010.

The second issue brought by the Association is in regard to private labeled goods. Currently if less than 50 percent of a business' total revenue comes from the sale of products it produces it is still considered a retailer and entitled to the .5 percent rate. However, the costs involved in the creation and production of these products is not deductible. Private label products and apparel is a growing popular item for consumers since it often provides better value to the name brand alternative. For example, department stores often create and produce their own line of clothing and housewares selling them under an in-house label. These items are often sold at a lower price alongside name brand items the department store has purchased for resale. It is the Association's position that the inability to deduct the costs runs contrary to legislative intent of the treatment of retailers and stymies the industry. Additionally, they argue that some of the businesses that manufacture private label items employ hundreds of employees and thus the issue raises Texas employment concerns. The Committee discussed that a possible fix is amending the definition of cost of goods sold, but also raised the concern that legislative intent may have been to recognize that a greater margin of income exists in creating and selling a product.[18]

Rent-A-Center, Inc. & subsidiaries also presented testimony regarding the inequity in the retailer definition and the of the higher tax rate applied to their business. Their business model provides rental items and also sells them on a rent-to-own basis. They recognize that the rent-to-own model is not typical of other retailers, but that all merchandise purchased by them is technically for resale. Unfortunately, the business model they use does not fit anywhere in the SIC manual and as such are unable to qualify for the retailer reduced rate.[19]

Worth noting is that in renting items, businesses like Rent-A-Center do not collect sales tax on the rental service, which is a bulk of their business. Businesses that sell the same items do collect a tax on sales. Therefore, if rental businesses were allowed to take the lower .5 percent rate, and thus pay less franchise taxes, the result would be a net loss in taxes to the state.

Compensation

As stated previously, the revised franchise tax allows a taxpayer to deduct compensation from total revenue. Compensation also includes costs related to employee health insurance, pensions, and other benefits. Businesses that use contract labor complain they cannot deduct compensation to those workers. Businesses that rely heavily on contract labor feel the tax is inequitable because often two competitors have different costs; one has deductable payroll costs for employees, while the other has non-deductible contract labor costs.[20]

Employers, however, face administrative costs, including tax withholding, social security, and unemployment insurance. The businesses that use contract labor may not. In large scale contract labor purchases the contracted business may pass those costs on to the contracting business, but in the case of small contract labor purchases such as day labor, the contracting business may not face those costs. Some business act as facilitators between other businesses.

[18] *Id.*
[19] Testimony by Hugh Tollack, Rent-A-Center, Inc. & Subsidiaries, House Committee on Ways and Means, August 17, 2010.
[20] Testimony, Bob Owens, Texas Society of CPAs, August 17, 2010.

In these cases, large portions of a business' revenue may just "pass through" the business.

For example, the Committee received testimony from the Texas Courier and Logistics Association (TCLA) representing courier companies and logistics brokers. TCLA states their business model, similar to other industries, contracts with multiple parties in the fulfillment of their service. One company may be hired to move a good, but that company may in turn hire one or more others to help move the good. The original shipping company may only receive a small profit because it had to pay fees to the other companies. Yet, for tax purposes the original company has to pay tax on the full amount even though a large portion was paid to other companies and cannot be deducted. They argue that the legislature's intention cannot have been to tax revenue that does not belong to a business. TCLA recommended use of IRS Form 1099 in order to substantiate the portion that is paid out to subcontracted parties, and using that amount as a deduction.[21]

The Committee also heard from AEG, Inc. ("AEG"), an entertainment related business, on the issue of pass through. AEG is engaged in the business of concert promotion; it contracts with an entertainer by assuring a certain fee or percentage of sales and manage the promotion of the event including ticket sales. Under the revised franchise tax, its margins are 100 percent of ticket fees and concession sales, even though a large portion of those ticket fees are contracted to the entertainer. It is not allowed to deduct or pass through the fee paid to the artist, which in their business is essentially their cost of goods sold. Additionally, they cannot take advantage of the compensation deduction since the artists are not the promoter's employees. AEG states that its industry is left with no deduction option for their costs.[22]

As for any suggested statutory change that would address their concern, AEG referenced House Bill 2391, which was filed during the 81st Legislature. They recognized that the fiscal implication of the bill would cost the state approximately $1.8 million, but they feel that in reality the costs should be lower since the figure assumes that 100 percent of the artists are or would be fully complying with the franchise tax themselves.[23] AEG points out that there are certain artists that do not pay the franchise tax since they come into the state for a maximum of 1 or 2 visits. In an effort to reduce the costs to the state, it would also be suggested to implement a withholding option reportable to Comptroller’s Office, although there was recognition that the option might present difficulties with regard to smaller scale performers. AEG pointed out that the use of a 1099 IRS Form is not a viable option since the great majority of the entertainers are incorporated or enjoy some other type of liability protected structure.

Combined Reporting

Under the old franchise tax, all entities were required to file a tax return regardless of any closeness in affiliation with a parent or sister company. Under the combined reporting provision of the new tax, entities that are part of a unitary group are required to file a single return for the

[21] Testimony by Eric Donaldson, Texas Courier and Logistics Association, House Committee on Ways and Means, May 25, 2010.
[22] Testimony by John Kroll, AEG, Inc., House Committee on Ways and Means, May 25, 2010.
[23] Fiscal Note, HB 2391, 81R.

entire conglomerate.

The Committee received testimony from the Texas Taxpayers and Research Association, (TTARA) regarding issues related to complexities in combined reporting. The problems arise in determining whether an entity is part of a unity group, and supports the activities and general operations of the conglomerate as required. TTARA points out that there are ambiguities in making this determination. It recognizes that there may be no real legislative fix to this issue since the test to make the determination is often a fact question for each company. The issue will work itself out with audit reviews, as is often the case with issues related to a new tax, particularly with one as unique as the revised franchise tax. TTARA recognizes that it is probably going to require taxpayer disputes through the administrative and judicial arenas to resolve the issue.[24]

Unprofitable Businesses

Businesses that lose money or fail to make a profit are still subject to a tax liability, regardless of their size. However smaller or family owned businesses are the ones that often feel a greater impact.[25]

The Committee acknowledged the concern voiced by many small businesses, however it was pointed out that allowing the tax liability to be based on profitability might run afoul of the Texas Constitution. The question to consider is whether applying the current franchise tax exclusively to a taxable entity that makes a profit constitutes a tax on net income. The Texas Constitution, Section 24, Article VIII, requires in part that any portion of a general law enacted by the legislature imposing a tax "on the net incomes of natural persons, including a persons' share of partnership and unincorporated association income," must provide that the portion not take effect "until approved by a majority of the registered voters voting in a statewide referenced held on the question of imposing the tax."[26] The Legislature in tackling this issue is going to have to work through several issues, such as what constitutes net income, natural person, and share, with no assurances that any change to the tax would be litigation proof. For a full discussion of the constitutional issues associated with exempting businesses that do not make a profit from the franchise tax, see Appendix A.

The Committee received testimony from the National Federation of Independent Business (NFIB) with regard to the impact the revised franchise tax is having on small businesses. It stated that one of their members experienced a $250,000 loss in FY 2009, which resulted in the layoff of 5 employees, yet was still subject to a $12,000 tax liability. Furthermore, NFIB argues that not only is the tax liability increasing for small businesses, but often doubling or tripling in amount. They suggest exempting small businesses from tax liability if they are losing money or are only marginally profitable.[27]

[24] Testimony, Dale Craymer, Texas Taxpayers and Research Association, August 17, 2010.
[25] *Id.*
[26] Section 24, Article VIII, Texas Constitution.
[27] Written and Oral Testimony by Kathy Barber, National Federation of Independent Business, House Committee on Ways and Means, August 17, 2010.

Another concern raised by NFIB is the high cost of compliance. As an example, NFIB reported that a business paying $400 in compliance costs and under the new tax must now incur a fee of $2,500 to have their CPA file its return. NFIB suggests a helpful change for small businesses would allow the cost of compliance to be deductable as cost of goods sold. Another option would be for a bifurcated system, thus allowing businesses that have gross receipts of $20 million or less to pay under the old franchise tax.[28]

Sourcing

In Texas the current system of apportionment of gross receipts is based on where a service is performed. Thus a Texas business has all of its gross receipts subject to the revised franchise tax even if some of it may be performed for out of state companies. Some argue that such apportionment reduces the attractiveness of the state to lure businesses that provide service in multiple states.[29]

Adequacy

As stated previously, a primary goal in revising the franchise tax was to ensure tax fairness and to increase the revenue from the tax to finance, in part, the reduction of school property taxes. To accomplish these goals the revised franchise closed many of the exemptions that existed and broadened the application of the tax.

The expectation was that the franchise tax would provide a reliable source of revenue for school districts, eliminate tax planning opportunities, and make the tax more accurately reflect the existing economy.

Although the revised franchise tax is raising more revenue than the original franchise tax the revenue performance of the tax has not met the expectations originally anticipated.[30] Revenue for the first three years of the tax failed to meet projections. For example, in fiscal year 2008, the tax produced $4.5 billion, significantly short of the $5.9 originally projected. Since 2008, the tax has consistently declined to $3.86 billion for fiscal year 2010.[31]

[28] *Id*.
[29] House Ways and Means Hearing, August 17, 2010.
[30] Testimony, John Heleman, Texas Comptroller's, May 25, 2010.
[31] The Business Tax Advisory Committee, Report to the 82nd Legislature, Texas Comptroller's Office of Public Accounts, December 2010 at page 18.

Franchise Tax Revenue ($billions)[32]

Fiscal Year	Revenue ($Billions)	Tax as Percentage of GSP	Percent of All Taxes	
2005	$2.17	0.23%	7.30%	**Old Earned Surplus Tax**
2006	$2.61	0.25%	7.80%	
2007	$3.14	0.28%	8.50%	
2008	$4.45	0.37%	10.80%	**Revised Franchise Tax**
2009	$4.25	0.35%	11.20%	
2010	$3.86	0.31%	10.90%	

According to the report by The Business Tax Advisory Committee, the primary reasons for the revenue short fall are: introduction of additional provisions and complexities to mitigate impact on certain businesses, complexities in business models, and the deterioration of the state's economy.

The revised franchise tax was in concept a simple tax: determination of taxable base is determined by total revenue reduced by either cost of goods sold, compensation, or a minimum deduction of 30 percent of revenue. Several provisions, which were introduced to assist small businesses such as an exemption for businesses with total revenue of less than $1 million ($600,000 in 2012 and beyond) and discounts for businesses with total revenue less than $900,000. Additionally a larger minimum deduction exists for business with under $10 million in total revenue, 42 percent rather than the standard 30 percent.

An added complexity is the tax's definition of which businesses are engaged in wholesale or retail trade and thus qualify for the lower rate of .5% of taxable revenue versus the standard 1%.

Determining which businesses can use the cost of goods sold deduction and which cannot has also created confusion and inequities. This ambiguity in definition resulted in more businesses taking the deduction than anticipated by the Comptroller's Office and is the main cause for actual revenues coming in below projections.

Additionally, the Comptroller's Office has recognized that complicated tax provisions and non-traditional businesses have added to the short fall because the estimate was based on more traditional models.[33]

The decline in the state's economy is another factor impacting revenue expectations and was unforeseen. For example, for fiscal year 2010, the Comptroller's Office original estimate of revenue from the franchise tax was anticipated to be $6.4 billion; however actual revenue was $3.86 billion. Of the $2.5 billion gap between the Comptroller's Office attributes $1.0 billion, to the recession as compared to the $1.5 billion to underperformance of the revenues compared to the original estimate.

[32] *Id*. at Table 17.
[33] *Id* at 19.

The Comptroller's Office reports that of the revised franchise tax did actually meet one of its goals since the broad application of the tax is actually more representative of the state's economy.[34]

Administrative and Compliance Issues

During the 81st Legislature members expressed concerns that the Comptroller's Office needed a more formal and aggressive audit structure in order to ensure compliance on what is still a relatively new tax. The Comptroller's Office updated the Committee on the current state of the audit process on the revised franchise tax.

The Comptroller's Office noted that the administration of the tax is still an ongoing process. For the first two years of the tax, 2007-2008, there was a focus on initial rule development, frequently asked questions development, form development, system development, educational webinars, and live training.

From 2008 to the present, there has been an ongoing engagement of enforcement by the agency that has resulted in $335 million in collections that were not initially remitted. The Comptroller's Office anticipates that collections should keep increasing.

The Comptroller's Office will continue to streamline the filing process, and anticipate that by 2011 they will have enhanced e-filing capabilities similar to the federal's government's e-filing system. The Comptroller's Office expects that the improvements will be very helpful for those businesses that file for multiple entities.

As for the resources currently devoted to the audit process, the Comptroller's Office believes its contingent of 600 auditors is sufficient. Of those auditors, 18 are full-time field auditors, 8 are full-time desk auditors, 28 are part-time out of state auditors, and 227 are part-time single entity auditors. Two hundred and fifty auditors, in one way or another, audit the revised franchise tax. A total of 2,700 audits have been completed, and of those, 768 were performed in the field and 1,900 were desk audits. One thousand nine hundred audits are ongoing. Of those 1,319 are field audits and 569 are desk audits.
The Comptroller's Office is taking a two-prong approach between desk audits that are focused on a single issue and long-term field audits of large taxpayers. A review of the desk audits so far reveal compliance issues in four areas.

First, over 1,051 taxpayers appear to have inappropriately taken the .5 percent tax rate even though they were ineligible. Second, 22,816 taxpayers in certain services industries may have incorrectly taken the cost of goods sold deduction, for which they may not be eligible. There are however some service industries, particularly mixed service and sales businesses, that sell tangible items that may not have taken the cost of goods sold exemption to their detriment.

Third, 12,794 taxpayers that may have taken excessive revenue deductions, such as cost of goods sold or compensation, prior to calculating their liability under the tax and thus merit further

[34] *Id* at 20.

review. These are concentrated around those using the E-Z calculations. Finally, there are 18,011 taxpayers that paid $119 million under the old tax but are not reporting any liability. The Comptroller's Office acknowledges that many of these taxpayers may in fact owe nothing, however further scrutiny is needed.

The Comptroller's Office notes that overall the revised franchise tax does bring in approximately 15,000 new taxpayers. The cost of administering those new taxpayers is not significantly higher than under the old tax. Initial implementation costs, however, were large.[35]

Future Audits

The Comptroller's Office states that their priority-one audits focus on 2,050 of the largest reporting entities, which combined, make up approximately 60 percent of all franchise tax revenue. Under combined reporting, those 2,050 entities can cover over 100,000 affiliates/entities. The Comptroller's Office anticipates that priority-one audits will occur over the next 3 to 4 years, due to the 4-year audit cycle. Given that cycle, audits on years covered by the old tax are producing approximately $200 million in additional revenue.

The Comptroller's Office states that the long term impact of the audits is difficult to predict since there are still some issues that have not been discovered or considered. Audit managers do not anticipate that the audits and/or subsequent litigation will significantly impact revenue. Estimators believe that for the next five years audits will not increase revenue more than $300 million per year.

Even with a rebound in the economy estimators don't anticipate the total franchise tax revenues will grow more than 5 billion a year over the next five years.[36]

[35] Testimony, Mike Reissig, Texas Comptroller's Office of Public Accounts, August 17, 2010. *See also* written testimony, "Franchise Tax Analysis and Audit Update" by Mike Reissig, Associate Deputy Comptroller's Office, Texas Comptroller's Office of Public Accounts, dated August 17, 2010.
[36] *Id.*

Charge 2

Examine the state's major tax exemptions to determine how the current costs and benefits compare with the original legislative objectives. Make recommendations for adjustments as needed.

The Speaker of the House directed the Committee to review all of the major tax exemptions and exclusion currently in existence. A major consideration for the Committee in this review was whether the original public purpose for creating the exemption is still valid. The Committee also tried to determine whether any significant administrative issues are associated with the exemption. Other issues considered included tax fairness, economic spinoff, and other public policy benefits other than tax issues.

The value of exemptions included in this section of this report, unless otherwise cited, come from the *Tax Exemptions & Tax Incidence, a Report to the Governor and the 81st Texas Legislature*, published in February 2009 by the Honorable Susan Combs, Comptroller's Office of Public Accounts. Because the report is updated every two years, the Committee acknowledges that some of the figures may become dated during the interim period, but the figures are still the most reliable estimates available.

It should be noted that the report states, "The exemption estimates are unadjusted amounts, meaning that elimination or repeal of a specific exemption would not necessarily produce the dollar amounts cited...." [37]

While the report outlines the value of exemptions to all major taxes, only in the sales and use tax section does the report clarify what is meant by value. The report states:

> Estimates of the (exemptions) values, that is the cost to the state government in lower sales tax revenue collections, are provided in **Table 1**. [Emphasis original]

The implication that the values of exemptions to other taxes means the cost to the state government in lower revenue collection seem obvious. Thus in this section of this report the terms value of an exemption, revenue loss, and cost of an exemption, will be used interchangeably.

[37] Tax Exemptions & Tax Incidence, A Report to the Governor and the 81st Texas Legislature by Comptroller's Office Susan Combs, pg. 1. The term "exemptions" as used in the overview section of *Tax Exemptions & Tax Incidence* includes exemptions, exclusions, discounts, deductions, special accounting methods, credits, refunds, and special appraisals. (footnote from page 1)

Franchise Tax

The franchise tax serves as the state's primary business tax and has existed in some form since 1907. The tax was originally levied as a tax on corporate assets, but by 1992 the computation had changed to a dual tax base of capital (net worth) and earned surplus (modified net income). In 2006, the tax underwent a major restructuring pursuant to HB 3, which was passed during the 79th Legislature, 3rd called session.[38] The primary changes in HB 3 were the inclusion of legal entities previously not subject to the franchise tax, such as partnerships and trusts, and the mandate for combined reporting, which requires commonly owned entities engaged in a unitary business to file one tax return instead of several.

Computation of the tax also changed dramatically. Previously the tax was based on a corporation's capital and earned surplus. The base for the revised franchise tax is determined by taxable margin, which itself is determined in one of three ways. Each method begins with a business's total revenue, and from that amount a business may deduct one of three amounts: cost of goods sold, compensation, or the standard deduction of 30%.

Exemptions, Deductions, Special Accounting Methods, and Credits and Refunds

The Comptroller's Office estimates all the exemptions and deductions for the franchise tax reduce state revenues approximately $2.1 billion in FY 2009 and $2.2 billion for FY 2010.[39]

Exemptions

Exemption - Certain Corporations & Certain Insurance Companies
Sections 171.052, 171.0525, Tax Code

An insurance organization, title insurance company, or title insurance agent that is authorized to engage in the insurance business in Texas and required to pay an annual premium tax levied under Chapter 4 or 9, Insurance Code, is exempt from the franchise tax. Licensed insurers are subject to the insurance "gross premium receipts tax"; the rate varies depending on the type of insurance provided. (*See* Chapters 221 through 223 of the Insurance Code.) The Comptroller's Office states that the nationwide gross premium tax average is 1.93 percent. Texas's gross premium tax rate is 1.6 percent, lower than the national average.[40] Farm mutuals, local mutual aid associations, and burial associations are also not subject to the franchise tax.

[38] For a more thorough discussion of the intent behind and changes made by HB 3, please refer back to Interim Charge No. 1 of this report.
[39] Tax Exemptions & Tax Incidence, A Report to the Governor and the 81st Texas Legislature by Comptroller's Office Susan Combs
[40] Testimony by Gary Johnson, Texas Comptroller's Office of Public Accounts, House Committee on Ways and Means, May 25, 2010.

The Comptroller's Office estimates that the value of the exemption is as follows:

2009	$495.0 million
2010	$519.8 million
2011	$545.7 million
2012	$573.0 million
2013	$601.7 million
2014	$638.8 million

The Committee received testimony from several groups on the exemption. The Texas Association of Life & Health Insurers, (TALHI) testified in support of the continuation of the franchise exemption for insurance companies contained in Section 171.052, Tax Code. TALHI states that although insurance companies are not subject to the franchise tax, they are subject to a gross receipts. The statutory exemption was purposely enacted in 1907, the same year when the premium tax was initially imposed. TALHI states that life and health insurers already pay significant taxes through the gross premium receipts tax and other state and local taxes, and points to the $1.4 billion in premium taxes paid by all types of insurance companies in Fiscal Year 2009. Specifically, life and health insurers alone paid approximately $700 million in Fiscal Year 2009.[41] TALHI maintains that the gross premium receipts tax revenue generates two and half times more revenue for the state than would a franchise tax. As evidence of the industries significant tax burden, TALHI cites to a 2005 Ernst & Young LLP study it commissioned, and submitted to the Committee, that shows life and insurance industry members paying more in state taxes in comparison to other industries, and that Texas taxes are higher than in any other U.S. state. The Ernst & Young study describes and quantifies the various state and local taxes as well as the gross premium receipts tax paid by insurance companies in Texas. The study notes that the state's premium tax is the largest component of the taxes paid by insurance companies, and that the rate paid is also higher than the franchise tax rate.[42]

The study was conducted prior to the revision of the franchise tax, and unless it is updated it is difficult to determine whether its overall findings are still accurate.

TALHI also argues that eliminating the franchise tax exemption would increase the cost of insurance. Insurance companies could also face losses because the additional tax could not be passed on to consumers holding existing life insurance policies. Insurers also note any property tax relief derived from the change in the franchise tax and including reduction in property tax rates was minimal for insurance companies because they do not own a lot of property.[43]

The Texas Association of Businesses, (TAB), presented written testimony supporting the exemption. TAB echoes the arguments made by TALHI that the exemption under the franchise tax exists because of the requirement of insurance companies to pay the premium tax.

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[41] *Id.*

[42] Oral and written testimony by Jennifer Cawley, Texas Association of Life and Health Insurers, May 25, 2010; *see also* ,"Talking Points, Franchise Taxes v. Premium Taxes, For Life, Accident and Health Insurance Companies", submitted on behalf of the Texas Association of Health Insurance.

[43] *Id.*

TAB added that state insurance taxes subject Texas companies to "retaliatory taxes", a tax imposed by another state on policies written outside of Texas by a Texas based company. The retaliatory tax is the difference between the tax liability in another state and the tax liability in Texas. For policies written in another state, Texas insurance companies must pay the tax liability in the other state or the tax liability in Texas, whichever is higher.

TAB also argues that eliminating the franchise tax exemption would result in premium increases for businesses and consumers since insurance companies would pass on the additional costs. At a time when companies are laying-off workers and struggling to stay in business, the Legislature should not make public policies that indirectly increase the costs for businesses, TAB claims.[44]

The Association of Fire and Casualty Companies reiterated the arguments made by TALHI and TAB, and added that insurance companies already pay substantial taxes such as sales taxes on the items they purchase and property taxes on their office space.[45]

Exemption - Open-End Investment Company
Section 171.055, Tax Code

An open-end investment company, defined by the Federal Investment Company Act of 1940, and that is registered under the Texas Securities Act, offers for sale, or has outstanding, any redeemable security of which it is the issuer. A mutual fund is an example of an open-end investment company. Section 171.055, Tax Code exempts about 155 companies from the franchise tax.[46]

The Comptroller's Office estimates the value of this exemption:

2009	$581.0 million
2010	$610.1 million
2011	$640.6 million
2012	$672.6 million
2013	$706.2 million
2014	$741.5 million

No one testified on the benefits of the exemption.

Exemption - Corporation with Business Interest in Solar Energy Devices
Section 171.056, Tax Code

A corporation engaged exclusively in the business of manufacturing, selling, or installing solar energy devices is exempt from the franchise tax. This exemption, originally granted in 1981,

[44] Written testimony, letter to Chairman Rene O. Oliveira on behalf of the Texas Association of Businesses.
[45] Written and oral testimony by Jay Thompson, Association of Fire and Casualty Companies of Texas, House Committee on Ways and Means, May 25, 2010; *see also* "Texas Franchise Tax Exemption for Insurers Impact on Texas Domestic Property/Casualty Insurance Companies", dated May 25, 2010.
[46] Testimony, Teresa Bostick, Texas Comptroller's Office, May 25, 2010.

exists to encourage the development of solar energy. There are currently 125 companies exempted under the provision.[47] The exemption also includes wind energy administratively even though the statute does not include wind energy.[48]

The Comptroller's Office estimates the following revenue losses of the exemption:

2009	$500,000
2010	$600,000
2011	$600,000
2012	$600,000
2013	$700,000
2014	$700,000

Meridian Solar, which installs photovoltaic systems, presented testimony in support of maintaining the exemption under section 171.056 and the deduction under section 171.107 of the tax code. Meridian Solar argued that the renewable industry in Texas is still a nascent one and therefore still in need of as much subsidy support as is feasible. The company states the exemption under 171.056 is needed in order to subsidize the cost of delivery of solar energy and to help offset operating losses in what is still a maturing market. It fears that losing either the deduction or exemption would result in the doubling of its franchise liability in FY 2011 from the current amount of $6,600. It stated that there are dozens of other small and growing renewable energy companies are in similar positions and in need of both the exemption and deduction allowed under the franchise tax.[49]

Exemption - Development Corporation
Section 171.074, Tax Code

A nonprofit corporation organized under the Development Corporation Act of 1979 (Subtitle C1, Title 1, Local Government Code) is exempt from franchise taxes. These are also known as 4A and 4B Economic Development Corporations. The purpose of a development corporation is to provide communities in Texas with a means for financing incentives for private industrial and manufacturing enterprises that will benefit the community. There are currently 2,070 exemptions granted pursuant to this provision.[50] The Comptroller's Office does not estimate the revenues to the state for this specific exemption and instead includes it with the estimates for 501(c) (6) organizations. The total those were $10.2 million in FY 2009.

The Committee received no testimony on the benefits of this exemption.

[47] *Id.*
[48] The Comptroller's Office attributed the inclusion of wind energy to a long standing Comptroller's Office policy. The Committee inquired but was unable to obtain information substantiating this policy and a review of the relevant administrative rule also did not specify any inclusion for wind energy.
[49] Written and oral testimony by Harold Marshall, VP of Operations of Meridian Solar, May 25, 2010; *see also* "Testimony to the House Ways & Means Committee", Re: Certain Franchise Tax Exemptions and Credit, dated May 25, 2010.
[50] Testimony, Teresa Bostick, Texas Comptroller's Office, May 25, 2010.

Exemption - Certain Homeowners' Associations
Section 171.082, Tax Code

A nonprofit corporation is exempt from the franchise tax if the corporation is organized and operated primarily to obtain, manage, construct, and maintain the common property in or of a residential condominium or residential real estate development, and, the collective individual resident owners control at least 51 percent of the votes of the corporation. A single individual or family, or one or more developers, declarants, banks, investors, or other similar parties must not hold voting control. A project is considered residential if the project or development is legally restricted for residential use. This exemption was created in 1981 and there are currently 7,020 companies that receive the exemption.[51]

The Comptroller's Office estimates the value of this exemption:

2009	$2.6 million
2010	$2.7 million
2011	$2.9 million
2012	$3.0 million
2013	$3.2 million
2014	$3.3 million

The Committee received no testimony on the benefit of this exemption.

Deductions and Exclusions

Rates; Computation of Tax
Small Business Exception
Section 171.002(d), Tax Code

Effective for reports due in 2008, businesses with a taxability of less than $1,000 and firms with total gross receipts of less than $300,000 were not required to remit the tax, although they were required to file information reports.

HB 4765, passed during the 81st Legislature, temporarily increased the exemption for small businesses from $300,000 to $1 million, for a period of two years effective for reports due in 2010 and 2011 (tax years 2009 and 2010 respectively). Beginning for reports due in 2012, the amount of the exemption will fall to $600,000.

[51] *Id.*

The Comptroller's Offices estimates the value of this exemption costs the state approximately:[52]

2010	$85.0 million
2011	$87.1 million
2012	$19.1 million
2013	$19.9 million
2014	$20.7 million

The Committee received no testimony on the benefits of this exemption.

Discounts from Tax Liability for Small Business
Section 171.0021, Tax Code

Prior to the 81st Legislature, a taxable entity with total revenue of less than $900,000 from its entire business was entitled to a discount of the tax determined under the standard or E-Z calculation. The graduated discount became effective in 2008 and applied to the 2008 and 2009 reports. However, due to the increase in the small business exemption to $1 million, by HB 4765, the discounts were done away with for the 2010 and 2011, reports. The discounts will return for the 2012 filings for entities with total revenue between $600,000 to $900,000 with a graduated discount from 20% to 40%.

- 40% of the calculated tax if total revenue is greater than $600,000 but less than $700,000;
- 20% of the calculated tax if total revenue is greater than $700,000 but less than $900,000.

If the amount of tax owed after application of the allowable discount is less than $1,000, the taxable entity owes no tax per the provisions of Section 171.002(d).

The Committee received no testimony regarding the benefits of these adjustments.

Adjustment of Eligibility for No Tax Due, Discounts, and Compensation Deduction
Section 171.006, Tax Code

The thresholds on total revenue for the small business exception (Section 171.002(d) and the brackets in the discount provisions (Section 171.0021) are adjusted at the beginning of each even numbered year by a percentage equal to the percentage increase or decrease in the Consumer Price Index for All Urban Consumers (CPI-U) during the preceding state fiscal biennium rounded to the nearest $10,000.[53] The first adjustment was in 2010, however due to the changes made by HB 4765, there were no adjustments made for FY 2010.[54]

A similar adjustment is made to the maximum allowable deduction for a single employee's compensation found in Section 171.1013(c), limited to $300,000. For 2010 reports, based on an increase in CPI-U, the deduction has increased to $320,000. The first adjustment became

[52] Fiscal Note, HB 4765, 81R.
[53] This figure is published monthly by the United State Bureau of Labor Statistics, or its successor in function.
[54] Testimony, Teresa Bostick, Texas Comptroller's Office of Public Accounts, May 25, 2010.

effective on January 1, 2010. The Comptroller's Office estimates the revenue loss to the state as a result of CPI-U adjustments are as follows:[55]

2009	$0.0
2010	$10.0 million
2011	$10.0 million
2012	$20.0 million
2013	$20.0 million
2014	$30.0 million

The Committee received no testimony regarding the benefits of this adjustment.

Deduction of Cost of Solar Energy Device From Margin Apportioned to This State
Section 171.107, Tax Code

Certain taxpayers may deduct 10 percent of the amortized cost of solar energy equipment installed from the taxable margin base. Unlike the deduction provided under Section 171.056, this exemption is for the purchaser of the equipment. A 'solar energy device' is defined as a system or series of mechanisms designed primarily to provide heating or cooling or to produce electrical or mechanical power by collecting and transferring solar-generated energy.

The Comptroller's Office estimates the value of this deduction is negligible.

Meridian Solar, which installs photovoltaic systems, presented testimony in support of maintaining the deduction under section 171.107 of the Tax Code.[56] Meridian Solar argued that the renewable industry in Texas is still a nascent one and therefore still in need of as much subsidy support as is feasible. It stated that there are dozens of other small and growing renewable energy companies in similar positions and in need of both the exemption and deduction allowed under the franchise tax.[57]

Deduction of Cost of Clean Coal Project From Margin Apportioned to This State
Section 171.108, Tax Code

The owners of FutureGen project may deduct 10 percent of amortized cost of equipment used in a clean coal project from the taxable margin base. The definition of "clean coal project" has the definition assigned to it by Section 5.001, Water Code, which is defined as the installation of one or more components of the coal-based integrated sequestration and hydrogen research project to

[55] These numbers do not reflect the impact of the temporary increase in the small business exemption, made by HB 4765, 81R, to $1million nor do they reflect the increase in the deduction for single employees made by the increase in CPI-U.
[56] Written and oral testimony by Harold Marshall, VP of Operations of Meridian Solar, May 25, 2010; *see also* "Testimony to the House Ways & Means Committee", Re: Certain Franchise Tax Exemptions and Credit, dated May 25, 2010.
[57] Written and oral testimony by Harold Marshall, VP of Operations of Meridian Solar, May 25, 2010; *see also* "Testimony to the House Ways & Means Committee", Re: Certain Franchise Tax Exemptions and Credit, dated May 25, 2010.

be built in partnership with the United States Department of Energy, commonly referred to as the FutureGen project. The term includes the construction or modification of a facility for electric generation, industrial production, or the production of steam as a byproduct of coal gasification to the extent that the facility installs one or more components of the FutureGen project.

The Comptroller's Office estimates the value of this deduction as negligible even though the value of the deduction is too small for the Comptroller's Office to compute and there is not a FutureGen project in Texas.

Laura Miller, with Summit Power testified to the Committee that the Clean Coal deduction is important to the state because it helps Texas be the cutting edge state in the nation for clean coal projects.[58]

Exclusion from Total Revenue for Handling Pro Bono Service Cases by Attorneys
Section 171.1011 (g-3)(3), Tax Code

Taxpayers who are attorneys may exclude from total revenue $500 per pro bono services case handled by the attorney, if the attorney maintains records of the pro bono services for auditing purposes. The Comptroller's Office estimates the value of this exclusion as negligible.

The Committee received no testimony regarding the benefits of this exclusion.

Exclusion from Total Revenue of Dividends and Interest Received on Federal Obligations
Section 171.1011 (m), Tax Code

Taxable entities are able to exclude from their total revenue, dividends and interest received from federal obligations. The Comptroller's Office estimates the value of this exclusion as follows:

2009	$17.6 million
2010	$18.5 million
2011	$19.4 million
2012	$20.4 million
2013	$21.5 million
2014	$22.6 million

The Committee received no testimony regarding the benefits of this exclusion.

Additional Subtraction of Newly Provided Health Benefit Costs for Certain Small Employers
Section 171.1013 (b-1), Tax Code

This section applies to small employers, as defined by Section 1501.002, Insurance Code (2-50 employees), that have not provided health care benefits to any of its employees in the calendar

[58] Testimony by Laura Miller, Summit Power, House Committee on Ways and Means, May 25, 2010.

year preceding the beginning date of the reporting period and that elects to subtract compensation for calculating taxable margin. If a qualified employer provides health benefits to all employees during the reporting period, the employer may subtract an additional amount equal to 50 percent of the cost of providing health benefits in the first 12-month period on which margin is based and an amount equal to 25 percent of the cost during the second 12-month period.

The Comptroller's Office estimates the value of the deduction as follows:

2009	$500,000
2010	$500,000
2011	$500,000
2012	$500,000
2013	$600,000
2014	$600,000

The Committee received no testimony regarding value of this deduction.

Special Apportionment of Method For Certain Investment Companies
Section 171.106(b), Tax Code

Most firms that provide services (as opposed to tangible goods) are required to apportion their receipts to the location where the service was performed. Section 171.106(b) apportions receipts from regulated investment company management services to the domicile of the owners of the investment funds. "Regulated Investment Company" has the meaning assigned to it by Section 851(a), Internal Revenue Code.

The Comptroller's Office estimates that the costs to the state of this type of apportionment as follow:[59]

2009	$6.5 million
2010	$6.8 million
2011	$7.2 million
2012	$7.5 million
2013	$7.9 million
2014	$8.3 million

The Committee received no testimony regarding the value of this type of apportionment.

[59] The Comptroller's Office in its report includes an estimate for costs related to apportionment under §§171.106(b) and (c).

Temporary Credit on Taxable Margin
Section 171.111, Tax Code

Under the previous franchise tax, businesses that lost money could carry forward a credit for some of its taxes due. This section preserved those credits when the franchise tax was revised in 2006. The provision was created in 2006. The credit is based on the amount of business loss carry forward of the taxable entity on tax reports due before January 1, 2008 that were not exhausted on a report due before that date.

The credit is calculated for reports due after January 1, 2008 and before January 1, 2018 as 2.25% of the unexhausted business loss carry forwards amounts times 4.5%. For periods after January 1, 2018 and before September 1, 2027 the credit equals 7.75% of the unexhausted business loss carry forward amounts times 4.5%.

A taxable entity that has properly notified the Comptroller's Office in writing may apply a tax credit against the franchise tax owed calculated on margin.

The Comptroller's Office estimates that the costs to the states of this credit are as follows:

2009	$50 million
2010	$50 million
2011	$50 million
2012	$50 million
2013	$50 million
2014	$50 million

The Committee received no testimony regarding the benefits of this credit.

Issuance of Tax Refund for Economic Development, Reinvestment Zone/Abatement Agreement
Section 111.302, Tax Code

In 1995, as part of school finance reforms, the Legislature generally banned school districts from abating property taxes. Because some school tax abatement agreements were being negotiated at the time, the Legislature created this refund. In 2008, 125 applications were granted, proportionate amount of refund of about 33-34% of amount paid. According to the Comptroller's Office, the applications are growing since inception in 1997, from 16 to 131 applications with 125 approved.[60]

To be eligible for a refund, a property owner must have established a new business in a Chapter 312 reinvestment zone or expanded or modernized an existing business located in the zone. There are also specific requirements that the property owner must meet with regard to payroll increases or an increase in the abated property's appraisal value. The total combined amount of

[60] Testimony by Teresa Bostick, Texas Comptroller's Office of Public Accounts, House Committee on Ways and Means, May 25, 2010.

franchise tax and sales tax refunded to all eligible taxpayers is capped at $10 million per fiscal year. The Comptroller's Office makes the determination which of the two taxes will be refunded. The entities eligible for this refund range in size from small to large. The amount refunded under this section is a fraction of what these businesses would have received as a property tax abatement, since the $10 million must be distributed among all taxpayers.[61]

The Center for Public Policy Priorities, (CPPP) testified that this section was created in response to changes made in 1993, which removed the hold harmless provision for school districts that granted tax abatements. This created a decline in the amount of abatements granted. There were some businesses that were relying on these tax abatements at the time and lobbied for the creation of this provision to serve as a transitional tool and thus make up for the loss of the abatements. CPPP stated that provision has outlived its usefulness since abatement agreements can only exist for a period of 10 years, and more than that length of time has elapsed since the changes made in 1993 and 1995. What exists now is a rotating pool of businesses that are not eligible for a school district abatement that are taking advantage of this provision.[62]

The Texas Taxpayers & Research Association argued that this should be considered more as an additional tax incentive to encourage businesses to come to Texas.[63]

The Comptroller's Office estimates that the costs to the state of this type of refund are as follows:

	Franchise	**Sales**	**Total**
2009	$1.3 million	$8.7 million	$10.0 million
2010	$1.3 million	$8.7 million	$10.0 million
2011	$1.3 million	$8.7 million	$10.0 million
2012	$1.3 million	$8.7 million	$10.0 million
2013	$1.3 million	$8.7 million	$10.0 million
2014	$1.3 million	$8.7 million	$10.0 million

[61] Testimony by Mike Reissig, Texas Comptroller's Office of Public Accounts, House Committee on Ways and Means, May 25, 2010.
[62] Testimony by Dick Lavine, Senior Fiscal Analyst, Center for Public Policies Priorities, House Committee on Ways and Means, May 25, 2010.
[63] Testimony, Dale Craymer, Texas Taxpayers and Research Association, May 25, 2010.

Property Tax

The Committee held a public hearing on April 20, 2010 to discuss a specific list of property tax exemptions and special appraisal provisions. The testimony consisted primarily of the Comptroller's Office summary of the exemptions and of special appraisals and current costs to the state.

Background

The Texas Property Tax Code and the Texas Constitution authorize local governments to levy property taxes to privately owned real estate (including land and buildings) and personal property used for business purposes. Property taxes are levied by counties, cities, school districts and special districts such as junior colleges, hospitals, and flood control districts. Although there is no statewide property tax, the taxes levied by school districts help the state meet its constitutional obligations to efficiently and adequately fund public education. The Texas Constitution states that all real and tangible personal property that the state has jurisdiction to tax is taxable unless it is exempted by law. The Constitution specifically exempts certain properties, primarily under Article VII, as does the Texas Tax Code under Chapter 11.

Below is a breakdown of 2009 exemptions:[64]

	Exemption	Billions ($)	% of Total
Residential	$15,000 Homestead	$73.7	31.2%
	65+ Freeze Loss	49.8	21.1%
	Local Option % Homestead	34.3	14.6%
	10% Residential Value Cap	14.8	6.3%
	$10,000 65+ Homestead	13.8	5.9%
	Local Option 65+ or Disabled	7.2	3.1%
	Veteran/ Surviving Spouse Homestead[65]	3.8	1.6%
	Historical Home Designations	0.3	0.1%
		$197.7	83.9%
Business	Freeport Exemption	$22.9	9.7%
	Pollution Control Exemption[66]	9.1	3.9%
	TX Economic Dev. Act (Chapter 313)	5.1	2.2%
	Low Income Housing	0.3	0.1%
	Tax Abatements	0.3	0.1%
	Solar and Other	0.3	0.1%
		$38.0	16.1%
Total		**$235.7**	**100.0%**

[64] Table presented by the Texas Taxpayers and Research Association, citing the 2009 Preliminary ISD Self Report, Comptroller's Office's Property Tax Assistance Division, April 20, 2010.
[65] HB 3613, 81st Regular Session, was effective immediately with passage of and approval by voters of HJR 36 on 11/3/09.
[66] HB 3206, 81st Regular Session, effective 9/1/09.

Agriculture

The single most valuable tax exemption granted to Texas farmers and ranchers is the open space land provisions under the property tax. Specifically, Article VIII, Section 1-d and 1-d-1, Texas Constitution, provides for appraisal of land designated for agricultural use and the taxation of open-space land devoted to farm, ranch, or wildlife management purposes on the basis of its "productive capacity" of the property, rather than its market value.

For purposes of estimating the value of agricultural and timberland exemptions, the *Tax Exemptions and Incidence Report* consolidates the exemptions into one estimate detailed after the discussions of those exemptions.

Land Designated for Agricultural Use
Article VIII, Section 1-d, Texas Constitution
Subchapter C, Sections 23.41, 23.42, Tax Code

To be designated land for agricultural use, three conditions must be met. It land must be devoted exclusively to or developed continuously for agriculture for the three years prior to receiving the special appraisal. The individual is using or intends to use the land for agriculture as an occupation or a business venture for profit during the current year. Agriculture is the individual's primary occupation and primary source of income. (Agriculture is defined as the use of land to produce plant or animal products, including fish or poultry products, under natural conditions but does not include the processing of plant or animal products after harvesting or the production of timber or forest products.)

Special Appraisal for Agricultural Open-space Land and Timber Land
Sections 23.41, 23.52, 23.72, and 23.9803, Tax Code

Certain land devoted to farm, ranch, or wildlife management purposes and timber land is appraised not at market value but at productivity value - a value based solely on the land's capacity to produce agricultural products.

Appraisal of Agricultural Land (Open-space land)
Subchapter D, Sections 23.51, 23.52, Tax Code

This agricultural appraisal is less restrictive than the appraisal under Sections 23.41 and 23.42. Two conditions must be met to qualify for special appraisal. The land must have been in agricultural use (i.e., raising livestock, producing crops, wildlife management, etc.) for at least five of the previous seven years before the chief appraiser designates it as open-space land. The land must be in agricultural use to the degree of intensity common to the area.

Appraisal of Qualified Timber Land
Subchapter E, Sections 23.73, Tax Code

In order to qualify for the special appraisal under this section the land must have been in use as timber land for at least five of the previous seven years before the chief appraiser designates it as

eligible for the special appraisal, and the land must also be in timber use to the degree of intensity common for the area. Either an individual or a corporation may own land that qualifies for this special appraisal, and the land need not be the primary source for the owners.

Appraisal of Restricted-Use Timber Land
Subchapter H, Section 23.9803, Tax Code

In order to qualify for this special appraisal, land must be in an aesthetic management zone, critical habitat zone, or streamside management zone. The land must also have timber harvested from it in a year in which the land was appraised, and the land has been regenerated for timber production to the degree of intensity generally accepted in the area for commercial timber.

The Comptroller's Office calculates the value for the special appraisal of agricultural land under §§ 23.41, 23.52, 23.73, and timber land under §23.9803 jointly. The calculation is the difference between market value and the special appraisal value. The exempted value by year is as a follows:

2009	$2,206.0 million
2010	$2,283.2 million
2011	$2,397.4 million
2012	$2,517.2 million
2013	$2,643.1 million
2014	$2,775.3 million

The Texas Landowner's Council, (TLC) testified before the Committee in support of maintaining the current valuation system. TLC testified if agricultural land is appraised on market value, there would be a rapid dumping of land on the market since the increase in taxes would make it difficult to profitably operate for agricultural purposes. The dumping of land on the market would spiral values downward.[67]

The Texas Southwester Cattle Raisers Association testified that the open space valuation is very important to the industry because profit margins are small. The number of cattle raisers is already decreasing and elimination of the special valuation would accelerate the decrease.[68]

The Texas Farm Bureau stated support for all the special appraisal valuations and argues that they are necessary in order to manage farms in a profitable manner. Losing the special appraisal valuations could negatively impact the production of food, which would result in higher prices for consumers.[69]

The Texas Wildlife Association (TWA) presented testimony raising several points in support of keeping the valuation of agriculture, wildlife, and timber lands. TWA argues that these

[67] Testimony by Jimmy Gaines, Texas Landowners Council, House Committee on Ways and Means, April 20, 2010.
[68] Testimony by Jason Skaggs, Texas Southwester Cattle Raisers Association, House Committee on Ways and Means, April 20, 2010.
[69] Testimony by Norman Garza, Texas Farm Bureau, House Committee on Ways and Means, April 20, 2010.

valuations only pertain to the land/property, not to improvements on the land. Current valuations help conserve agricultural lands and wildlife habitat, which provide intangible environmental benefits. Nature-related recreation areas are large and increasing economic generators as people seek out areas to fish, hike, hunt, and enjoy the outdoors.[70]

The Texas Sheep & Goat Raisers Association testified the open-space land valuation is needed in order to maintain open space at a time with rapid urbanization and suburban sprawl.[71]

The Harris County Appraisal District testified to the Committee that it regularly looks for changes in land use and generally does not find abuses. With the Tax Code's five-year roll back provision, abuse is curtailed because landowners want to avoid the roll back. The provision encourages land to stay in production. Though abuse is rare, the district suggested requiring periodic, every five .years, application for designation of the land instead of the current one time application.[72]

The Texas Department of Agriculture reiterated the importance of agriculture to the state's economy and consumers. Agriculture comprises $106 billion of state's economy, which is approximately 9.5 percent. Moreover, Texas enjoys one of the safest, most affordable food supplies in the world. These valuations should not be construed so much as an expense but as a savings to consumers. According to the department Texans spend the least amount of their income on food than most countries across the globe.[73]

Residence Homestead (School Property Local Option)
Article VIII, Sec. 1-b, Texas Constitution
Section 11.13(n) and (d), Tax Code

The residence homestead exemption, the most familiar of the property tax exemptions, applies to owner-occupied homes in Texas. A school district must grant an exemption of $15,000 from the market value, and an additional $10,000 from the market value of a homestead owned by disabled adults or those aged 65 years or older.

The Committee's focus, however, was on the optional exemptions from school taxes enacted in 1981. These exemptions allow a governing body of a school district to grant an additional exemption of up to 20% of the market value of a residence homestead with a minimum of at least $5,000. Additionally, the governing body of a school district may grant an additional exemption of at least $3,000 of the market value of a residence homestead for adults who are disabled or 65 years of age or older.

[70] Written testimony, presented by Kirby Brown, Vice President for Public Policy, Texas Wildlife Association, dated April 20, 2010.
[71] Testimony by Bob Turner, Texas Sheep and Goat Raisers Association, House Ways and Means Committee, April 20, 2010.
[72] Testimony by Jim Robinson, Chief Appraiser, Harris County Appraisal District, House Committee on Ways and Means, April 20, 2010.
[73] Testimony by Drew DeBerry, Texas Department of Agriculture, House Committee on Ways and Means, April 20, 2010.

The Comptroller's Office found that during 2009, 211 school districts had approved the local option exemption for disabled or over 65 individuals and 217 adopted the percentage exemption. The Comptroller's Office testified that it appears that the number of districts granting the exemption is holding steady, if not decreasing.[74] Statewide, $40 billion of property is exempted by these districts. For a listing of the districts granting optional exemptions and their value, see Appendix B, for a list of school districts offering the optional $3,000 exemption see Appendix C.

The Comptroller's Office estimates that the cost to the state is as follows:

§11.13(n) optional exemption of up to 20%:

2009	$428.2 million
2010	$452.6 million
2011	$478.3 million
2012	$505.4 million
2013	$534.1 million
2014	$564.4 million

§11.13(d) optional exemption: age 65 and older or disabled:

2009	$92.6 million
2010	$96.0 million
2011	$99.5 million
2012	$103.1 million
2013	$106.9 million
2014	$110.8 million

The Center for Public Policy Priorities, (CPPP), testified that the Legislature should repeal the provision of the Education Code that allows the Commissioner of Education to replace local revenue lost to the optional homestead exemption. Section 42.2522, Education Code, permits the Commissioner of Education to replace up to 50 percent of local revenue lost due to the optional homestead exemption if there are surplus funds available in the Foundation School Fund Program after dispersing all the money owed to school districts.[75] Because the Legislature does not generally appropriate more FSP money than is necessary to fund schools, only twice in the last decade have surplus funds been available.

The CPPP also argues that the cost to the state of the optional homestead exemption, an estimated $478 million in 2011, benefits too few school districts and primarily wealthy homeowners with a family income of over $118,000 per year.

CPPP points out that the current school finance system links state expenditures to local property

[74] Testimony, by Debbie Cartwright, Director of Property Tax Assistance, Texas Comptroller's Office of Public Accounts, April 20, 2010.
[75] Testimony, Dick Lavine, Senior Fiscal Analyst, Center for Public Policies Priorities, House Committee on Ways and Means, April 20, 2010.

tax values, since it guarantees each school district a certain "target revenue" per student. When local property values are too low or when they are reduced by exemptions, Section 42.2522 of the Education Code allows the Commissioner to make up the difference. Under current school-finance rules the Commissioner may replace one-half of the revenue that school districts lost to the optional homestead exemption.

CCPP states that the one-quarter of school districts offering the optional homestead exemptions are clumped in certain areas such as Houston and Dallas. The Houston Independent School District, accounts for more than one-quarter of the total cost to the state of the exemption. When combined with Cypress-Fairbanks and Dallas Independent School Districts, the three school districts receive nearly one-half of the statewide benefit.

CPPP points out that a district with less reliance on residential property in its tax base is more likely to offer the exemptions because the exemption has less impact on its total taxable value. As evidence, it states that two-thirds of the districts that grant the exemptions come from districts where less than 30 percent of their property wealth is comprised of residential homesteads.

Additionally, CPPP further argues that the optional homestead exemption is one of the most regressive in the tax code, since more than half of the benefits received by homeowners goes to the one-fifth of households with an annual income of more than $117,000. Only 13.5 percent of the benefit goes to the two-fifths of the families with an income of less than $49,100 per year. The CPPP gathered these estimates from the *Tax Exemption and Tax Incidence Report*.

Additionally, according to the CPPP homestead exemptions burden business property owners since ultimately a school district must increase the tax rate to make up for the value lost to homestead. Therefore, since only a small majority of districts grant the exemptions and with the benefits of the exemptions flowing to only a handful of districts and higher-income homeowners, the CPPP suggests the Legislature should remove the requirement to the state to replace the revenue lost due to this exemption.[76]

The Committee did not receive testimony regarding the benefits of these exemptions.

While the Comptroller's Office estimates the value of the optional homestead exemption as a cost to the state, it is not clear that eliminating the exemption would result in any state savings, due to the complexity of the state's school finance system. Each district is assigned a "target revenue" amount, which is the total of local and state funds. Districts offering the local option homestead exemption generally received a lower target revenue than they would have received without the exemption, because the loss of local revenue due to the exemption lowered their total revenue entitlement in the target years.

If the local homestead exemption option were eliminated or the school finance formulas were to change so that districts granting the optional exemption did not receive any revenue benefit from the resulting increase in local revenue, those districts would likely request that their target revenue be adjusted upward since it was originally lowered because they were granting the

[76] *Id.*

optional exemption. Such an adjustment would either lessen recapture payments or increase state aid, possibly negating any contemplated savings.

The Table below - reproduced from the *Tax Exemptions and Incidence Report* - shows the distribution of the value of the exemption by household income quintile.

Quintile	Household Income	Amount	Percent of Tax Paid	Tax as a Percent of Total Income
1	less than $27,088	$ 28.9	6.0%	0.1%
2	$27,088 to $49.112	36.1	7.5%	0.1
3	$49.112 to $75,402	47.0	9.8%	0.0
4	$75,402 to $117,899	71.5	15.0%	0.1
5	$117,899 and over	208.7	43.6%	
Residents		$392.2	82.0%	
Exported		$ 86.1	18.0%	
TOTAL		$478.3	100%	

Mineral Interest Having a Value of Less Than $500
Article VIII, Section 1, Texas Constitution
Section 11.146, Tax Code

A person is entitled to an exemption from property taxation of a mineral interest if the taxable value is less than $500. This provision was added during the 74th Legislature and has been in effect since January 1, 1996. The cost of administering and collecting the tax at anything less than $500 would cost more than the tax collected.[77] The Comptroller's Office due to unavailable appraisal data, does not calculate the cost to the state.

The Committee received no testimony in support of the benefits of this exemption.

Farm Products
Article VIII, Section 19, Texas Constitution
Section 11.16, Tax Code

Producers are entitled to an exemption from property taxes for the farm products that they produce and own. This exemption has been in effect since 1879.[78] Farm products include crops, livestock, poultry, and timber. Additionally, nursery products in a growing state are exempt. Farm products must be in the "hands of their producers" in order to receive the exemption. With regard to timber, the term means standing timber or timber that has been harvested and is on the real property on which it was produced and is under the ownership of the person who owned the timber when it was standing. The cost to the state is not calculated by the Comptroller's Office due to unavailable appraisal data.

[77] Testimony, Debbie Cartwright, Texas Comptroller's Office, April 20, 2010.
[78] *Id.*

The Committee received no testimony regarding the benefits of this exemption.

Implements of Husbandry
Section 11.161, Tax Code
Article VIII, Section 19A, Texas Constitution

All machinery and equipment items that are used in the production of farm or ranch products or timber are considered to be implements of husbandry and exempt from taxation regardless of their primary design. The Constitutional provision does not require ownership, just use, so lease equipment is eligible for the exemption. The exemption would apply to the lessor and the lessee.[79] The costs to the state are not calculated by the Comptroller's Office due to unavailable appraisal data.

The Committee received no testimony regarding the benefits of this exemption.

Miscellaneous Exemptions
Section 11.23, Tax Code

Some entities are specifically exempted from property taxes and are identified under this section of the Property Tax Code. The Committee did not address every entity exempted under this section, only those it considered pertinent by the Chairman of further review. The Comptroller's Office stated they do not collect information for these exemptions. There are concerns that these exemptions might run afoul of the Texas Constitution since these entities/organizations may not be operating exclusively for a primarily chartable function as required under Article VIII, Section 2.[80] No direct evidence was presented.

Bison, Buffalo, and Cattalo
Section 11.23(f), Tax Code

The exemption of bison, buffalo, and cattalo applies only to those animals not held for profit and those used in experimental breeding to produce an improved meant strain or animals kept in parks to preserve the species. The costs to the state are not calculated by the Comptroller's Office due to unavailable appraisal data.

The Committee heard from John Meng with the Texas Bison Association expressing general support of this exemption.

Congress of Parents and Teachers
Section 11.23(d), Tax Code

The Texas Congress of Parents and Teachers state headquarters buildings are exempt from state and county taxes. The Property Tax Code provides that the organization's land that is reasonably necessary for use of, access to, and ornamentation of the buildings is also exempt. The cost to

[79] *Id.*
[80] *Id.*

the state is not calculated by the Comptroller's Office due to unavailable appraisal data.

The Congress of Parents and Teachers, (PTA) submitted testimony to the Committee outlining the services and benefits offered by the PTA to the state and how their property exemption facilitates that service. The PTA states that their exemption applies solely to one physical location, which is the building that serves as their state headquarters. From that one location they serve over 2,800 PTA units, 100 councils, 18 areas and over 600,000 members.

The PTA argues that their move to the current location in 1937 was motivated in part from its strong public policy history, which includes many legislative achievements, participation in formation of the State Board of Education, and their overall advocacy for Texas children over the past 100 years. For these reasons and others, they point out that the Internal Revenue Service granted the PTA a 501(c)(3) tax-exempt status. They further argue that by maintaining their property exemption they are able to invest a greater portion of the revenue received towards services, educational presentations, and advocacy. The PTA also points out that as an owner/occupier they do not anticipate selling or leaving the location and do not hold the property for investment gain.[81]

County Fair Associations
Section 11.23(h), Tax Code

A county fair association organized to hold agricultural fairs and encourage agricultural pursuits is entitled to an exemption from taxation of the land and buildings that it owns and uses to hold agricultural fairs. The property must be used exclusively for a primarily public charitable function. The costs to the state are not calculated by the Comptroller's Office due to unavailable appraisal data.

The Committee received no testimony in support of the benefits of this exemption.

Nature Conservancy of Texas
Section 11.23(c), Tax Code

This organization is entitled to an exemption from taxation of the tangible property it owns if the property is not held for gain, as long as the organization is a nonprofit corporation as defined by the Texas Non-Profit Corporation Act. The costs to the state are not calculated by the Comptroller's Office due to unavailable appraisal data.

The Nature Conservancy submitted written testimony in which they offered their support for the elimination of the exemption. The reason behind their decision to support elimination is that the entity, as it existed at the time of the exemption's enactment, no longer exists as a named, stand-alone organization. It appears that since enactment, the organization has become a Texas chapter of the national and international non-profit organizations, The Nature Conservancy. As a result, they no longer use the exemption and instead, it is the Chapter's policy is to pay property taxes

[81] Testimony by Kyle Ward, Executive Director, Congress of Parents and Teachers, April 20, 2010; *see also* written testimony submitted by The Texas Congress of Parents and Teachers.

on their preserves or make payment in lieu of taxes.[82]

Private Enterprise Demonstration Associations
Section 11.23(e), Tax Code

Tangible real and personal property that is owned and used exclusively by a qualified private enterprise demonstration organization and that is reasonably necessary for the organization's operations qualifies for a total exemption. To qualify, the organization must engage exclusively in conducting nonprofit educational programs to demonstrate the American private enterprise system to children; and operate under a similar state or national organization set for the same purpose. The Comptroller's Office is not aware of any organizations claiming the exemption. The cost to the state is not calculated by the Comptroller's Office due to unavailable appraisal data.

The Committee received no testimony in support of the benefits of this exemption.

Tangible Personal Property Exempt (Freeport Property) Section 11.251, Tax Code
Article VIII, Section. 1-J, Texas Constitution

The "Freeport exemption" applies to goods transported out of Texas within 175 days of acquisition in the state. Goods are defined as the property listed in Article VIII, Section 1-j of the Texas Constitution and includes goods, wares, ores and merchandise, except oil, gas and petroleum products. The constitutional provision came into effect in 1989. Certain types of local taxing units may continue to tax the property if the unit's governing bodies took action, grandfathered, to do so prior to April 1990. The taxing units can later decide to exempt the property but once it is exempt it must remain so.

Freeport Property and Cotton Stored in a Warehouse
Section 11.437, Tax Code
Article VIII, Section VIII, Sec. 1-j, Texas Constitution

A person who operates a warehouse used primarily for the storage of cotton for transportation outside of the state is also eligible for the "Freeport" exemption, regardless of the 175 day requirement.

The Comptroller's Office calculates the value of the exemptions under Sections 11.251 & 11.437 jointly. These values are perceived to be growing, but out years estimates may be lowered due to the recent economic downturn.[83] School districts are not held harmless when they grant these exemptions. The Texas Education Agency stated that the school finance system does not have a way to recognize a loss of local collections specifically caused by "Freeport" exemptions, however if a school district has a significant loss of collection that causes less revenue in their compressed tax rate, it could result in the school district receiving additional state aid to make up

[82] Written testimony, letter written to The Honorable Rene Oliveira, Chair, House Ways and Means Committee by The Nature Conservancy, dated April 20, 2010.
[83] Testimony, John Helemen, Texas Comptroller's Office, April 20, 2010.

for those losses. A more direct impact to school districts from these exemptions would likely occur with regard to a reduction of dollars collected for enrichment funding for Tier 2 schools.[84]

The Comptroller's Office estimates the loss of revenue due to the exemption as follows:

2009	$302.9 million
2010	$317.1 million
2011	$350.3 million
2012	$403.6 million
2013	$448.9 million
2014	$508.1 million

The Texas Taxpayers and Research Association recognizes that the "Freeport" exemption is the largest exemption enjoyed by the business community, but states that it is a necessary exemption. Businesses need the exemption to stay competitive, especially since only two states (Alaska and West Virginia) fail to exempt at least some portion of "Freeport" property. Because businesses receive few property tax exemptions, they are essentially taxed at the effective local tax rate. This exemption is particularly important to businesses since Texas has one of the highest property tax rates of any state in the nation. Even after the recent property tax relief initiative, Texas has the third highest effective tax rate of any state, according to TTARA. Such a high rates creates a barrier to new investment in Texas.[85]

Tangible Personal Property in Transit
Section 11.253(b), Tax Code

Goods in transit, which are used for manufacturing, processing, fabricating, storing, and assembling in the state, are exempt from property taxes. The goods are not required to leave the state in order to qualify for the exemption. This is a local option exemption, and the local taxing jurisdictions can change taxability on a yearly basis. Goods in transit does not include oil, natural gas, petroleum products, aircraft, dealer's motor vehicle inventory, dealer's vessel and outboard motor inventory, dealer's heavy equipment inventory, or retail manufactured housing inventory. The costs to the state are not calculated by the Comptroller's Office due to unavailable appraisal data.

The Committee did not receive testimony regarding the benefits of this specific exemption.

Solar and Wind Energy Devices
Section 11.27, Tax Code
Article VIII, Section 2A, Texas Constitution

Solar or wind-powered energy devices are subject to exemption. The amount of a property's appraised value attributable to the installation or construction of solar or wind-powered energy

[84] Testimony by Lisa Dawn-Fischer, Texas Education Agency, April 25, 2010.
[85] Written and oral testimony by Dale Craymer, Texas Taxpayers and Research Association, April 20, 2010; see also written testimony "Texas Property Tax Exemptions: Looking at the Big Picture.

devices may be exempt. The exemption is allowed for residential and business taxpayers. The devices must be used for on-site production and distribution of energy.

The Comptroller's Office estimates the value of the exemption:

2009	$2.7 million
2010	$2.9 million
2011	$3.1 million
2012	$3.3 million
2013	$3.5 million
2014	$3.7 million

The Sierra Club, Lone Star Chapter (Sierra Club), testified in support of the exemption. It states that, although there are federal tax credits available for solar and wind devices and increased availability of credit and rebates to make wind and solar more affordable to the average homeowner, the exemption is still worthwhile. Most states in the U.S. offer a similar exemption for residential use. There are also others that grant the exemptions for power plants that utilize renewable energy.

The Sierra Club does suggest that the statute's language merits some clarification. First, the language of the exemption lacks a definition of 'person', thus, in their opinion, making it unclear whether the exemption is available to commercial and industrial facilities.[86] The result has led to conflicts between proposed exemptions and solar installation for commercial and industrial facilities. The Sierra Club would like to see clarification that the exemption also applies to devices intended for use at the site of commercial or industrial facilities, with a provision that would limit the size of the facility to 2 or 5 MWs. Additionally, the Sierra club would like to ensure that the exemption does not apply to those facilities whose principle purpose is not to save the use of electricity but actually sell the electricity on the market for a profit.[87]

Solar Alliance & Applied Materials Co. also came before the Committee to support the exemption in order to protect property owners that choose to invest in alternative energy sources in an effort to reduce their energy expenses.[88]

Offshore Drilling Equipment Not in Use
Article VIII, Section 1-I, Texas Constitution
Section 11.271, Tax Code

An owner or lessee of a marine or mobile drilling unit designed for offshore drilling of oil or gas wells is entitled to an exemption from taxation of the drilling unit if certain requirements are met.

[86] It is worth noting that the Texas Code Construction Act in defining a person includes a corporation. Section 311.005, Government Code

[87] Written testimony, "Comments of Lone Star Chapter of Sierra Club on Property Tax Exemptions, by the Sierra Club, Lone Star Chapter, Cyrus Reed, Conservation Director to the House Ways & Means Committee, dated April 20, 2010.

[88] Testimony by Steve Taylor, Solar Alliance & Applied Materials Co, April 20, 2010.

The drilling unit must be stored in a county bordering the Gulf of Mexico or in an adjacent body of water in the Gulf of Mexico. The unit must not be stored for the sole purpose of repair or maintenance, and the unit is not being used to drill a well at the place where it is being stored. This exemption has been in place for approximately 15 years. The costs to the state are not calculated by the Comptroller's Office due to unavailable appraisal data.

The Committee did not receive testimony regarding the benefits of this exemption.

Inter-coastal Waterway Dredge Disposal Site
Section 11.29, Tax Code

The exemption applies to land dedicated by a recorded donation easement as a disposal site for depositing and discharging materials dredged from the main channel of the Gulf Inter-Coastal Waterway or under the direction of the state or federal government. An exemption terminates when the land ceases to be used as an active dredge material disposal site and is no longer dedicated for that purpose. The costs to the state are not calculated by the Comptroller's Office due to unavailable appraisal data. The Comptroller's Office states this exemption was found to be unconstitutional in 1994 pursuant to Attorney General Opinion No. DM- 301, since there is no constitutional authorization for the exemption.[89]

The Committee did not receive any testimony regarding the benefits of this exemption.

Certain Water Conservation Initiatives
Article VIII, Section 1-M, Texas Constitution
Section 11.32, Tax Code

Property on which approved water conservation initiatives, desalination projects, or brush control initiatives have been implemented are eligible for a local option tax exemption. The costs to the state are not calculated by the Comptroller's Office due to unavailable appraisal data and there is no information regarding how many jurisdictions are offering this type of exemption.[90]

The Committee did not receive any testimony regarding the benefits of this exemption.

Raw Cocoa and Green Coffee held in Harris County
Article VIII, Section 1-N, Texas Constitution
Section 11.33, Tax Code

Harris County property only is entitled to this property tax exemption. The Comptroller's Office states that in 2009, 71 exemptions were granted with a total value of the property exempted of $59.6 million.[91]

[89] Testimony, Debbie Cartwright, Texas Comptroller's Office, April 20, 2010.
[90] *Id.*
[91] *Id.*

Several parties testified that the exemption is necessary for the "exchange coffee" industry. The industry warehouses and trades coffee as a commodity and the exemption permits the Port of Houston to participate in Ice Futures US (ICE).[92] Exchange coffee encompasses the second largest traded commodity in the world after energy. ICE does not permit the warehousing and trading of exchange coffee in jurisdictions where inventory taxes were imposed on exchange coffee.

Proponents argue that repealing the exemption would result in decreased revenues and increased costs, due to a loss of business activity, in excess of the amount the taxes would raise. They state that the estimated costs are approximately $350,000 per year. They argue that since the exemption's enactment a new industry in Texas was born with increased shipments through the Port of Houston, a new demand for leasing of warehouses, additional demand for the use of rail lines and truck transportation, as well as providing a need for smaller ancillary businesses related to the importation and storage of exchange coffee. Particularly, the industry has had significant impact on the Houston economy and the surrounding region.

They also argue that in being a designated exchange coffee port, improved efficiencies were created to existing coffee manufacturers throughout the state. Houston is now one of only four exchange coffee ports in the United States, and the only port west of the Mississippi. These manufacturers perform a variety of services for national and regional coffee brands such as: roasting, decaffeination, the manufacturing of instant coffee, as well as packaging and transportation. The proximity of the exchange coffee located in Houston reduces the production costs for these manufacturers. Lastly, proponents state that the impact of the exemption is not complete as evidenced by the continuous increase in the economic activity of Houston, Harris County, and the state. They claim that the exemption is essential for this continued growth and that with the completion of the Panama Canal expansion project (a deepening and widening of the canal) in 2014 there will be an expansion of trade routes between Houston and East Asia and the western coast of South America.[93]

Tax Increment Financing Act
Article VIII, Section 1-g, Texas Constitution
Chapter 311, Tax Code

A tax increment financing (TIF) zone is a designated area that a city or county uses to publicly finance improvements and infrastructure to promote and attract new developments within that area. The tax revenue collections generated by the increase of the property value inside the TIF zone are used to finance development costs. As of 1999, Section 403.302, Government Code, prohibits the deduction from a school district from participating in TIFs.[94]
According to the Comptroller's Office, the value of TIF exemptions in zones in which school

[92] The New York Board of Trade was renamed ICE Futures US in September 2007, and is a wholly owned subsidiary of Intercontinental Exchange. ICE is a physical commodity futures exchange located in New York City.
[93] Written testimony, letters to the Honorable Rene Oliveira, Chairman, House Ways and Means Committee from Maximus Coffee Group dated June 1, 2010; Gulf Winds International, Inc. dated April 19, 2010; Houston East End Chamber of Commerce dated April 19, 2010; and Economic Alliance, Houston Port Region undated.
[94] Testimony, Debbie Cartwright, Texas Comptroller's Office of Public Accounts, April 20, 2010.

districts participated prior to 9/1/99, are as follows:

2009	$152.8 million
2010	$150.0 million
2011	$150.0 million
2012	$150.0 million
2013	$150.0 million
2014	$150.0 million

The Committee received testimony on behalf of the City of Houston and the Community Redevelopment Coalition, (CRC), which provided a background into the creation and implementation of TIFs and opposed to any effort would negatively impact TIFs in Texas.

The City of Houston and CRC's primary concern is that there be an understanding that TIF is not a tax exemption nor a tax abatement, instead that it is the use of specific future tax revenues to finance public infrastructure improvements within a specified area. The TIFs redirect existing local tax revenues to areas that are deemed worthy of such focus, particularly areas that blighted, deteriorated, or underutilized areas of local jurisdictions.[95] To clarify the distinction, the supporters offered a bit of background in the evolution of TIFs in Texas. [96]

As noted in the heading, Chapter 311 of the Tax Code is the authorizing statute for TIFs, which gives local governments authority to designate tax increment reinvestment zones (TIRZs). The statute, enacted first in 1981, permitted municipalities and a few counties to use TIF to pay for public infrastructure improvements to streets and roads, utility relocation and expansion, landscaping parks, street lighting, and security among others.

The City of Houston argues that the concept is based on an expectation that if a specific public infrastructure project is accomplished, then the private property benefitting from the project will see an increase in property value which will generate increased tax revenue; the increased revenue the "tax increment". TIRZs may function on a pay-as-you-go basis or may issue debt, using the incremental tax revenues to service the debt. These TIRZ can last for a few years or as much as 15 to 30 years, depending on the amount of time that is needed to pay for the improvements. The City of Houston and CRC point out that some TIRZ rely only on property taxes, some only on sales, and some on a combination of the two.

They also point out that while initially school districts could also participate in a TIRZ, since 1999, any newly participating school districts will have any payments made by them counted against them in equalizing school funding. As such, school districts that join a TIRZ after 1999 do not impact the state budget. The City of Houston points out those subsequent amendments to

[95] *Id.*

[96] Written testimony, letter to The Honorable Rene Oliveira, Chairman, Ways & Means, Re: Consideration of Tax Increment Finance, on behalf of the City of Houston, Tim Douglass, Deputy Director, Finance, Economic Development, dated April 20, 2010; *see also* letter to The Honorable Rene Oliveira, Chairman, Ways and Means, Re: Consideration of Tax Increment Finance, on behalf of CRC Community Redevelopment Coalition, John R. Breeding, President, Community Redevelopment, dated April 20, 2010.

the statute have minimized financial exposure to the state. Since then few school districts are joining TIRZ projects. As for those school districts that contracted prior to 1999, the City of Houston points to the Texas Education Agency as stating that approximately 33 school districts remain and these are in fact held harmless by the state for the remaining years of their contracts in the TIRZ. They state that any cost to the state will terminate as the "life" of each TIRZ comes to an end.

With regard to the benefits, the City of Houston acknowledges being the municipality that has most aggressively utilized TIFs with approximately 22 TIRZ projects. It credits the use of TIRZ as the cause of critical urban redevelopment in the city. They also point out that a result is an increase in retail and hotel development in the areas, which is producing significant increases in state sales and hotel occupancy taxes. The City of Houston also state that other cities such as Dallas and Plano can also point to areas redeveloped with TIRZ money that have seen higher property values and higher sales and hotel tax revenues. The City of Houston argues that there are numerous cities that have had success with TIRZ, and the tool should remain available.[97]

Texas Economic Development Act
Chapter 313, Tax Code
Article VIII, Section 1-g, Texas Constitution

Firms, including corporations and limited liability companies, making a certain level of investment and creating jobs in specified numbers are entitled to a limitation on the taxable value of qualifying investments. The tax limitation only applies to property used in connection with manufacturing; research and development; a clean coal project as defined by Section 5.001, Water Code; an advanced clean energy project as defined by Section 382.003, Health and Safety Code; renewable energy electric generation; electric power generation using integrated gasification combined cycle technology; or nuclear electric power generation. The purpose of the tax limitation is to promote economic growth by encouraging business to build new facilities or improve existing ones. Once the tax limitations end, the investments go on the tax rolls at full value providing more local money for schools, lessening the state's public education financing burden.

The Comptroller's Office approximates that the value of these types of abatements as follows:

2009	$ 82.1 million
2010	$182.5 million
2011	$282.9 million
2012	$302.0 million
2013	$294.8 million
2014	$277.3 million

Chapter 313 was enacted in 2001 and allows communities to attract development by offering a tax credit and an eight-year limitation on appraised property value for the maintenance and

[97] *Id.*

operations portion of the school district property tax. For a business to qualify for Chapter 313, the local school board must find that the project is reasonably likely to increase primary employment, benefit property values, and contribute to regional economic development.[98]

The property owner must agree to create a specific number of jobs and to build or install specific types of real and personal property of a certain value in order to receive the appraised value limitation and tax credit. This agreement must also include provisions to protect the school district from revenue losses.

The minimum job creation requirement for non-rural districts is 25 and at least 10 new jobs must be created in rural districts. In 2007, the Legislature passed a law that allowed for the minimum job creation requirement to be waived in some circumstances. Since then, approximately 65% of the agreements initiated have waived the minimum job requirement. Regardless of the number of jobs required to be created in the agreement (even if the requirement is waived), at least 80% of all new jobs must be qualifying jobs. Qualifying jobs must meet three standards: provide certain health care benefits, work at least 1600 hours per year, and pay 110% of one of three wage targets. If these standards are not met, HB 3676, 81st Legislature, requires the termination of the agreement. The required minimum investments must be made in two years (two full tax years and one partial year), beginning when the school district approves the application.

In order to obtain a value limitation, first the property owner must file an application form with the school district. If the school district decides to consider the application, it must send a copy to the Comptroller's Office and the relevant appraisal district and ask the Comptroller's Office to provide an economic impact analysis. The Comptroller's Office will then decide if the project is eligible and notify the school district of the determination. If the Comptroller's Office recommends against the project, the school district may still approve the project with a 2/3 vote. The school district may approve the application only if it finds that the information on the application is true and correct, the applicant is eligible for the limitation, and granting the application is in the best interest of the school district and state.

Some other major changes were made to Chapter 313 during the 81st Legislature and they are:

- Required school districts to submit to the Comptroller's Office copies of most documents, and required the Comptroller's Office to post each document on the Comptroller's Office website. Districts are required to have links to the Comptroller's Office website.

- Required the Comptroller's Office to determine whether the property described in the application meets the eligibility requirements of the chapter, and offer applicants the opportunity for a hearing on project eligibility.

- Expanded the Comptroller's Office economic impact evaluation.

[98] Testimony, Robert Wood, Director of Local Government Assistance and Economic Development, Texas Comptroller's Office of Public Accounts, House Committee on Ways and Means Committee, April 20,2010

- Allowed agreements to include a provision for payments from the business to the school district for "extraordinary education-related expenses" related to the project.
- Limits "supplemental payments" from the project owner to the district to $100 per student per year for the duration of the project.

- Specified that the Comptroller's Office shall not deduct from the school district value study the value of any Chapter 313 projects that are applied for after May 1, 2009, and not recommended by the Comptroller's Office.

The Comptroller's Office proposed rules based on the new laws and published them in Texas Register on March 19, 2010.

The Texas Taxpayers and Research Association presented testimony that said Chapter 313 keeps Texas competitive with other states in spite of its high property taxes. Chapter 313 does not remove property from the tax rolls; it simply delays the time at which new investment property is placed on the tax rolls at full value. As of 2009, there are 90 agreements worth $41 billion in new investment under Chapter 313, with over $5 billion of property value on the tax rolls at the limited value. Four thousand four hundred new jobs have been created, often before most projects are operational.

According to TTARA, Chapter 313 does not cost the state money. It makes the state money by attracting new capital investment. Every job in Texas generates an average of $851 in school taxes paid by employers. Every job at a Chapter 313 project generates an average of $9,255 in property taxes with value limited. If the values were not limited, every job at a Chapter 313 project would generate an average of $19,733 in school taxes.[99]

The Center for Public Policy Priorities stated that two controversies have stemmed from the law change. One has been the rules change allowing for the job creation waiver. There has been concern that the job creation waiver is retrospective, meaning that current projects who do not currently meet the job creation standards would be able to qualify for the waiver. Upon examination of the legislation and the economic impact statement, CPPP argues that this is not true, and that the job waiver would only be made available to new projects. The second controversy is that annual reporting is permitted, but not mandated for all projects. CPPP believes this report should be mandated and that the Comptroller's Office should verify the results in the report. During the testimony presented, it was also clarified that out of the 4,400 jobs that have been created by Chapter 313, half have came from one project.[100]

Chapter 313 projects seem to be grouped into two groups. A few projects offer a very high investment and create a lot of jobs. The spin-off is a boost to the economy. Other projects, such as wind, offer a great deal of capital investment and create few jobs at the project site. Some argue that wind should be considered separately from Chapter 313 because of this. One suggestion is to have the Legislature reconsider Chapter 313 and separate it into two to three different programs with one program for large scale industrial projects, one for wind projects,

[99] Oral and written testimony, Dale Craymer, Texas Taxpayer and Research Association, April 20, 2010
[100] Testimony, Dick Lavine, Center for Public Policy Priorities, April 20, 2010.

and one for nuclear projects.[101]

The Wind Coalition testified to the Committee that the wind industry pays millions in property taxes and has created 10,000 jobs in the State of Texas. He stated that it is important to note that unlike other Chapter 313 projects, they are creating an entire industry that will benefit the entire state and not just one project, which solely benefits one community. Currently, Texas is leading the country in the creation of the wind industry. A change in Chapter 313 could take the competitive edge away from Texas. In Kansas, lifetime abatement is given to the wind industry and in Oklahoma the wind industry gives a 100% tax credit for five years. Texas gives a partial abatement for eight years.

Following the public hearing on April 20, 2010, an informal working group was established to begin work on crafting any changes that would need to be made to Chapter 313 during the 82nd Legislature. Membership in the informal working group was open to all interested parties. At this time, no finalized agreement or changes has been developed.[102]

[101] *Id*.
[102] Testimony by Paul Sadler, Executive Director, Wind Coalition, House Committee on Ways and Means, April 20, 2010.

Sales and Use Tax

Texas' largest source of revenue is the sales and use tax. The sales tax is assessed on the final sale of all tangible goods or specified services. The sales tax was enacted in 1961 with a 2% rate. Since then the rate has increased several times to its current state level of 6 1/4 %. Local governments are permitted a 2% sales tax. In FY 2008, sales and use tax collections totaled $21.5 billion, but had fallen to $19.5 billion in 2010 due to the economic recession.[103] The Comptroller's Office estimates exemptions, exclusions, and discounts cost the state approximately $30 billion in FY 2009.

Exemptions

Installation of Certain Equipment for Export
Section 151.3071, Tax Code

Electronic audio equipment purchased in Texas for use outside the U.S. is exempt from Texas sales tax even if the equipment is installed in Texas. This section was added in 1993. The Comptroller's Office estimates the value of this exemption as negligible.

During the discussion of this exemption, the broader issue of exports in general was raised. Generally all items exported to another country or state are entitled to a sales tax refund upon proof of export. In Texas these exemptions occur primarily along the border with the use of customs brokers, but brokers do work at outlet malls and other large retail establishments across the state. Mexican nationals purchase items along the Texas/Mexico border, take personal possession of the items, and export them to Mexico.

Section 151.307 of the Tax Code details the requirements to qualify for the refund; first a foreign national pays the tax to the retailer then, must provide documentation to a customs broker evidencing foreign citizenship and the intention to transfer the item across the border. The foreign national then returns to the retailer with the documents provided by the customs broker to obtain a refund of the sales tax. The customs broker is required to authenticate foreign citizenship and intention to export, however, there is often no real knowledge that items are exported so the system can be abused.[104] Other states require items to be directly exported by the retailer in order to exempt the sales tax.

The exemption at issue specifically applies to electronic equipment installed in a vehicle, which would necessarily require that the vehicle to be registered in Mexico and have Mexican plates so as to ensure the equipment will more than likely be exported to Mexico. Again, as with the customs broker issue, the individual installing the equipment really has no direct knowledge that the vehicle is going to cross the border. By installing the equipment into the vehicle, the

[103] Comptroller's Office's Office, General Revenue-Related Monthly Collections (through November 2010, provided by John Heleman).
[104] For a thorough discussion of the customs broker system *see* Texas State Government Effectiveness and Efficiency repot "Strengthen Sales Tax Enforcement Related To Customs Brokers and Increase the Charge for Export Stamps, prepared by the Legislative Budget Board Staff, to be published January 2011.

purchaser is able to avoid using the customs broker system.

The primary policy issue served by maintaining these types of exemptions is to promote business along the Texas border by encouraging consumer spending by foreign nationals in Texas.[105]

The Comptroller's Office stated there is not a specific number regarding the costs related to administrating these types of exemptions, since costs are not broken out specifically for exports. Auditing occurs as part of a broader audit of a specific retailer. The Comptroller's Office recognizes that there is room for abuse, as in all exemptions. Although there are no hard numbers for the specific exemption of equipment installation, the Comptroller's Office states costs associated with the refund of the sales tax through the customs broker system were $112 million for FY 2009.[106]

Water - Bottled Water
Section 151.315, Tax Code

This provision of the sales tax code exempts all water, and does not distinguish between bottled water and any other water. Water has long been exempt, with the provision being enacted in 1961 when the sales tax was originally implemented. Not included in this provision is the disposal of wastewater, which is a nontaxable service. Unlike soft drinks, bottled water falls within the aforementioned provision and therefore is not assessed a sales tax even though bottled water is often purchased in the same manner as soft drinks which are taxable, for example via a vending machine purchase or at a retail store.

The Comptroller's Office estimates in computing the value of the exemption does not specify bottled water, or any specific source for that matter, and assesses the costs of the exemption for water as a whole as follows:

2009	$248.5 million
2010	$254.9 million
2011	$261.4 million
2012	$268.2 million
2013	$275.2 million
2014	$282.4 million

Those opposed to assessing a sales tax consider bottled water as food, which is not taxed, and should therefore remain exempt. They argue that bottled water is a staple grocery item for many Texas families and sometimes the only source of drinking water. Assessing a sales tax, they argue, would decrease consumption and would be regressive in nature given that household budgets for the poor, who presumably purchase bottled water, would be more negatively impacted. There was no discussion on the availability of tap water, which is also untaxed, as an

[105] Bryant Lomax, Manager of Tax Policy Division, Texas Comptroller's Office of Public Accounts, House Committee on
Ways and Means, February 10, 2010.
[106] Testimony by Robin Corrigan, Texas Comptroller's Office's Office, February 10, 2010.

alternative source to bottled water.[107]

The Committee recognized that there have been many proposals for quite some time to eliminate the exemption for bottled water. The Comptroller's Office estimated that the approximate revenue raised by taxing bottled water, including small bottles and large office sized ones, but excluding flavored or carbonated water, would raise approximately $70-80 million over a biennium.[108] It also stated that there would be an administrative burden in taxing bottled water since there currently exists a structure to do so.[109]

Basic Fee for Internet Access Service
Section 151.325, Tax Code

This section exempts the first $25 of a monthly charge for Internet access service. "Internet access service" is defined by §151.00394, Tax Code, as a service that enables users to access content, information, electronic mail, or other services offered over the Internet. This would include service obtained at a specific location like a home or business, and service acquired via wireless cards. Not included in the definition are any of the taxable services listed in §151.0101(a), unless the service is provided in conjunction with and is merely incidental to the provision of Internet access service. The exemption applies regardless of whether the access service is bundled with another service, including any other taxable service, or to the billing period used by the Internet access service provider. The exemption applies on a per account basis even if there are multiple points of access.[110] Amounts in excess of $25 are subject to the sales tax. This exemption was added in 1999.

In reviewing this exemption, the Committee assessed whether the need for this exemption is still necessary if presumably the original intention was to make Internet access more affordable when the Internet was in its infancy. More than ten years has elapsed since the establishment of the exemption and the argument can be made that the availability of Internet access, due to an increase in providers and advancement of technology, is now more affordable and almost ubiquitous. Arguments in favor of retaining the exemption are that it encourages Internet usage, which should be a goal of the state since increased use results in a more educated populace and creates workforce opportunities.[111] Additionally, there are areas, mostly rural, of the state where there are few providers and costs of acquiring internet access still keep it out of reach for many individuals.

Of additional concern is whether a repeal or reduction in the exemption would violate the federal Internet Tax Freedom Act (ITFA), or as it is commonly referred to, the Internet tax moratorium. The Act, which was signed in 1998, prohibits state and local entities from imposing new taxes on internet access service. The act has been renewed numerous times since then, most recently in

[107] Testimony by Ish Arebalos, Texas Beverage Association, House Committee on Ways and Means, February 10, 2010.
[108] Testimony by John Heleman, Texas Comptroller's Office of Public Accounts, House Committee on Ways and Means, Feb2013ruary 10, 2010.
[109] Testimony, Br2014yant Lomax, Texas Comptroller's Office, February 10, 2010.
[110] Testimony, Robin Corrigan, Texas Comptroller's Office, February 10, 2010.
[111] Written testimony, Todd Baxter, Texas Cable Association.

2007. Therefore, some argue that it is clear that Congress intends to preserve state and local tax treatment of Internet access service. Eliminating or reducing the exemption might be considered a new tax in violation of federal law.

The Comptroller's Office estimates the revenue loss of the exemption as follows:

2009	$84.9 million
2010	$89.4 million
2011	$94.1 million
2012	$98.8 million
2013	$103.7 million
2014	$108.9 million

Information Services and Data Processing Services
Section 151.351, Tax Code

Twenty percent of the value of information services and data processing services are exempt from the sales tax. This section was added in 1999. The exemption was created primarily to attract high paying jobs to prevent out-of-state companies from taking businesses away from Texas. Prior to the implementation of this exemption, the total value was taxable. Taxation among states varies from no taxation of either service to full taxation as tangible personal property.[112] It is unclear what impact a partial exemption has on demand for these services[113]

According to the Federation of Tax Administrators, a 2007 Survey shows 12 jurisdiction tax information services in one way or another and 8 jurisdictions tax data processing. Taxation varies from everything from a gross receipts tax to a sales tax. Because many of these services can be performed out of state for Texas residents and companies at little or no extra cost, some are concerned additional taxation could make it impossible for Texas companies to compete with out of state vendors.[114]

The Comptroller's Office estimates the revenue loss to the state to be as follows:

2009	$37.4 million
2010	$38.8 million
2011	$40.5 million
2012	$43.2 million
2013	$46.1 million
2014	$48.7 million

[112] Testimony, Robin Corrigan, Texas Comptroller's Office, February 10, 2010.
[113] Testimony, John Heleman, Texas Comptroller's Office, February 10, 2010.
[114] Testimony, Jack Kennedy, Texas Taxpayers and Research Association, February 10, 2010.

Aircraft
Section 151.328, Tax Code

Aircraft sold to a person using the aircraft (1) as a certificated or licensed carrier of persons or property; (2) sold to a person using the aircraft for training or instructing pilots in a licensed court of instruction; (3) sold to a foreign government; or (4) sold to a person for use and registration in another state or nation is exempt from taxation. Included recently in the exemption is the use of aircraft for wildlife management and agricultural use.[115]

Additionally, the repair, remodeling, and maintenance services performed on aircraft operated by carriers or flight schools and the machinery and equipment used in performing such repair services are exempt from the sales tax. Also exempted are the sales of tangible personal property permanently affixed or attached as a component part of an aircraft operated by a carrier or flight school.

The Comptroller's Office estimates that the value of the exemption relating to the sale of aircraft as negligible. The figures are primarily related to the sale for crop dusting and flight training purposes. Values attributable to sales to foreign governments are not included under this provision and pertain generally to exemptions due to exports. Figures relating to repair as follow:

2009	$16.4 million
2010	$17.2 million
2011	$18.1 million
2012	$19.0 million
2013	$19.9 million
2014	$20.9 million

Proponents of maintaining the exemptions for the sale of aircrafts and associated services state that Texas state policy, including tax policy, is a primary draw to Texas hosting three major airlines: American Airlines, Continental Airlines, and Southwest Airlines. Not only do airlines purchase planes, but they also employ maintenance services and purchase plane parts.[116]

Certain Ships and Ship Equipment
Section 151.329, Tax Code

This section exempts sales of (1) component parts of a vessel of eight or more tons displacement and used in a commercial enterprise or used commercially for pleasure fishing by individuals as paying passengers on the vessel; (2) a commercial vessel of eight or more tons displacement sold by the vessel's builder; (3) materials and labor used in repairing or converting a commercial vessel of eight or more tons displacement; (4) materials and supplies for a vessel operating exclusively in foreign or interstate coastal commerce used in the maintenance and operation of the vessel or become component parts of the vessel; and (5) certain materials and supplies purchased by a provider of stevedoring services for a qualifying vessel.

[115] Testimony, Bryant Lomas, Texas Comptroller's Office, February 10, 2010.
[116] Testimony by Dan Hagan, American Airlines and the Air Transport Association, February 10, 2010.

The Comptroller's Office estimates this exemption costs the state as follows:

2009	$31.3 million
2010	$34.0 million
2011	$36.0 million
2012	$38.0 million
2013	$40.4 million
2014	$42.6 million

The bulk of the exemption's values pertain to the sale of large ships with the smaller portion attributable to stevedoring services. The bulk of the value data is derived from federal sources and difficult to obtain. Additionally, some of the value associated with sales fall within values associated with exports.[117]

Proponents of maintaining the exemptions state the exemptions are needed since the client base for these services are very mobile, even global, and without the exemptions these clients may move to another state or country for the same basic services.[118] They argue that the services are extremely price sensitive, and Texas already has an uneven playing field with regard to other coastal states such as Louisiana, Mississippi, and Alabama that rely on their respective states for subsidies and investments of some sort or another.

Coin-operated Services
Section 151.335, Tax Code

Amusement and personal services provided through coin-operated machines that are operated by the consumer are exempt from the sales tax. Coin-operated amusement machines are currently licensed and taxed under a separate statute. (Chapter 2153, Occupations Code) The machines are required to maintain a decal on display with each machine, and operators must be licensed and pay a fee to own and operate the machines. Each decal is worth $60 to obtain and must be renewed on an annual basis. As of February 2010, there were over 100,000 decals in use.[119] The current amount was set in 1991, when it was doubled from $30.[120] This section was added in 1984.

The Committee reviewed this exemption in part because it was originally enacted 30 years ago. Another reason is that the exemption does not list nor thoroughly describe what services are included or provided via coin operated machines. The Committee also wanted to explore whether the cost of the decal was close to what a sales tax collection might be.

[117] Testimony, John Heleman, Texas Comptroller's Office, February 10, 2010.
[118] Testimony by Steve Hale, Gulf Copper and Manufacturing Corporation, February 10, 2010.
[119] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[120] Testimony, John Heleman, Texas Comptroller's Office, February 10, 2010.

The Comptroller's Office estimates this exemption to cost the state as follows:

2009	$57.5 million
2010	$61.1 million
2011	$64.7 million
2012	$68.4 million
2013	$72.2 million
2014	$76.2 million

From the testimony presented at the hearing, it appears that the type of services provided by machines that are the subject of this exemption include pool tables, jukeboxes, shuffleboard, clothes washers and dryers, and a variety of video games, among others. Proponents of maintaining the exemption argue that as a result of increased competition in other amusement services (i.e. computer games, television, and games played on mobile devices) there is a decline in the use of coin operated machines. Testimony was presented citing a significant decrease both in the number of machines and the annual gross revenue for just about every type of coin-operated amusement machine.

Additionally, proponents argue that a significant administrative burden exists for both the operators of these types of machines and for the Comptroller's Office to collect sales taxes. Operators would face a time-consuming challenge of trying to maintain detailed records on the sales from a machine at each location. Many operators have over 100 machines located in dozens of locations. A single operator may have machines located in multiple taxing jurisdictions with differing rates of local sales tax. Proponents state that it would be difficult and expensive to audit for compliance since no paper trail exists on a per transaction basis and auditing would have to rely solely on the operators accounting books.

Proponents also argue that it is physically difficult to collect the sales tax from the consumer since no direct interaction exists between the consumer and the operator. If operators were forced to comply with sales tax collection, they would have to either raise prices to cover the sales tax or simply absorb the sales tax expense at current prices. Either option would result in a loss of revenues. According to proponents, a loss of revenue would severely impact the industry since most of these types of businesses operate on very slim margins. The result, they argue, would be a loss of revenue for the state.

Certain Coins and Precious Metals
Section 151.336, Tax Code

The sale of gold, silver, or numismatic coins, or of platinum, gold, or silver bullion, is exempt if the total sales price of all of the items sold equals $1,000 or more. This exemption applies solely to the bulk purchase of the items, and does not include retail sale.[121] This section was added in 1989. The Comptroller's Office estimates the costs of this exemption to the state as negligible. Data is extremely difficult to obtain and a good amount of buying and selling occurs without the

[121] Testimony, Bryant Lomax, Texas Comptroller's Office, February 10, 2010.

purchaser ever taking possession of the items.[122]

The Committee did not receive testimony regarding the benefits of this exemption.

Cooperative Research and Development Ventures
Section 151.348, Tax Code

This provision exempts qualifying items sold in connection with a joint research and development venture as defined by 15 U.S.C., Section 4301 to an entity participating in the venture, if the items are created or substantially modified by or for the joint research and development venture. It also exempts purchases by a joint research and development venture, notice of whose establishment and participants was first published in the Federal Register on January 17, 1985, or May 19 1988. The section was added in 1987 and expanded in 1989, and established specifically for two Austin based business entities. The Comptroller's Office has determined that the costs to the state cannot be estimated especially there is no knowledge of what purchases these two companies make.[123]

The Committee did not receive any testimony regarding the benefits of this exemption.

Services by Employees of Property Management Companies
Section 151.354, Tax Code

Otherwise taxable services provided by permanently assigned, on-site employees of property management companies are not subject to the sales tax. In order for the exemption to apply a rental property owner who hires a management company must have the employee permanently assigned to the property of the owner and the property owner must fully reimburse the management company for employee-related costs. If these requirements were not met than the services would be taxable.

Proponents argue that the exclusion is narrowly tailored and that losing it would create a significant cost disparity between two functionally equivalent alternatives. For example, if a property owner hired a full-time employee instead of using a property management company, the service provided would be a not be taxed. If however the property owner hired a management company the work provided would be taxed. They argue that by removing this exclusion, property owners who utilize property management companies would be unfairly penalized.[124]

The Comptroller's Office estimates the revenue loss due to the exemption is negligible. Additionally, they state that were this service taxed it would be easy to avoid the tax by merely hiring the in-house employees.[125]

[122] Testimony, John Heleman, Texas Comptroller's Office, February 10, 2010.
[123] *Id*.
[124] Written testimony, letter submitted to the House Ways and Means Committee from Texas Building Owners and Managers Association, dated February 19, 2010.
[125] Testimony, John Heleman, Texas Comptroller's Office, February 10, 2010.

Sales Tax Exclusions: Services

Since the inception of the sales tax in 1961, the sales tax was not imposed on the sale of services. However, starting in the early to mid-1980s, certain services have become subject to the sales tax. Specifically in 1984, the sales tax was imposed on laundry and dry cleaning, amusement admissions, cable television service, auto parking, most non-automotive repair services and certain personal services. In the following years, the tax was extended to intrastate long-distance telephone service, repair and remodeling of nonresidential real property, data processing, landscaping and lawn maintenance, janitorial and extermination services, security services, garbage removal, credit reporting and debt collection, information services, certain surveying services, and insurance services. However, as of today, many services still remain excluded from the tax. The Comptroller's Office estimates that value of the services not taxed was expected to exceed $5.3 billion in FY 2009, more than one-quarter of total expected sales tax collections.[126]

The largest group of services excluded from the sales tax is professional services. These include dental, and other health care; legal services; accounting and audit services, engineering and architectural services; real estate brokerage; financial securities brokerage; and veterinary services. However, it is worth noting that individuals engaged in these professional services are assessed a $200 occupation fee, in addition to other license fees. Another large exclusion is for labor charges by contractors on new residential and nonresidential construction jobs. Labor for residential repair and remodeling also remains tax-free. The materials used in construction jobs, however, are subject to sales tax.[127]

Why Examine Sales Taxes on Services?

As of October 2008, Texas taxed more services than the average among the states according to the Federation of Tax Administrators, *Sales Taxation of Services: 2007 Update*. To this date, Texas taxes 83 out of 168 services and only 6 states tax more services than Texas. Texas also currently taxes 25 out of the 40 household services listed. Some states still have not implemented a system that taxes services because of the impracticality and costliness of administration, the high probability of evasion, and the high amount of services consumed by low-income individuals.

During the March 25, 2010 hearing, testimony was presented to the committee based on a paper by Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities. The testimony presented at the hearing provided a brief overview of the issues surrounding the taxation of services. [128]

[126] Tax Exemptions & Tax Incidence, A Report to the Governor and the 81st Texas Legislature, Texas Comptroller's Office of Public Accounts, February 2009.
[127] *Id*.
[128] Dick Lavine with the Center for Public Policy Priorities presented the PowerPoint *Sales Taxation of Services: Options and Issues* by Michael Mazerov. Mr. Mazerov was scheduled to appear before the committee but was unable to due to weather related travel issues.

Mr. Mazerov contends that the state's economy would benefit from expanding the sales tax to include services by improving the sales tax and the tax system in general. Taxing services could:

- Generate substantial new sales tax revenue by raising revenue on untapped sources.

- Reduce the year-to-year volatility of current sales tax collections, based on the sale of tangible items; by mitigating fall-off in revenue during recessions because most people postpone tangible purchases but still need to use services.

- Increase fairness by raising "horizontal equity", equally treating people who spend the same amount of money on services as those who spend on goods (i.e. individual who buys Netflix should be taxed the same as individual who buys a DVD).

- Improve the allocation of economic resources. An unnecessarily high sales tax rate from too narrow a base creates adverse economic incentives, such as artificial stimulation of demand for non taxed products.

- Simplify the process of administering and complying with the sales tax for businesses that sell tangible goods (taxable) and services (tax-exempt), (i.e. a car shop owner sells car parts (taxable goods) along with car repair (tax-exempt service). Right now, since only goods are taxed in a total sale, businesses must determine the proper amount of taxes collected and remitted. But with all sales taxed, both goods and services, the proper amount of tax is more simply accounted for.

- Reduce compliance costs for businesses and enforcement costs for states by the previously described simplification of administration and compliance.

- Maintain long-run revenue adequacy of the sales tax by mitigating current long-term erosion of sales tax as people spend less on tangible goods and more on services.

- Help the sales tax revenue grow as rapidly as the services are, since the economy is shifting so quickly from goods consumption to services consumption.

Expanding the sales tax to include services could create several disadvantages. Some concerns are that including services would:

- Bring in many new retailers into the tax system. These new retailers would have to be registered, educated, have returns processed and be audited, thus increasing the amount of time and cost for the state to ensure compliance. However, the increase in new retailers might not be as large as it seems, since many service providers already sell taxable goods or self-remit use tax.

- Increase substantial non-compliance from businesses that either provide "off-the-book" services or provide services to low-income communities. In either case, service providers will be hesitant to document services provided since doing so would require an increase in the prices charged. Therefore, it would be difficult for the government to collect all

necessary information to ensure compliance.

A sales tax on services could increase the regressive nature of a sales tax, since a broad taxation of services would undoubtedly also include services used by those of lower socio-economic status. It is Mr. Maserov's position, that in order to avoid the regressive impact of the tax, it should only be extended to services primarily used by affluent individuals and coupled with the creation of a low-income relief program, which can be accomplished through two options. The first option is to create a "revenue neutral" sales tax package that would cut the sales tax rate just enough to where state revenue can increase but low-income families will not have to pay much more. The second option is to implement a state personal and/or corporate income taxes that usually are progressive, while, simultaneously, offsetting tax cuts for low-income households. Washington D.C., along with 22 other states, have targeted cuts for low-income wage earners and households by providing refundable earned income tax credits (EITCs) on their state's income tax.[129]

In suggesting which services to tax, Mr. Mazerov states that services sold to businesses (business-to-business sales), services sold to households, and services frequently sold to both should all be included in the expansion of sales taxes. However, he acknowledges that a case can be made against taxing business-to-business sales of services because this results in a pyramiding of the tax. There are several reasons why a pyramiding of the tax would not be beneficial: taxes on the service would only add to the cost of a final product; there is a lack of transparency in the taxation of the cost of the final product; there are possible adverse economic developmental impacts; "vertical integration" would increase, hurting economic efficiency; and, it would create a competitive disadvantage for small businesses. According to Mr. Mazerov, the advantages for engaging in tax pyramiding are: there is less economic distorting over simply increasing the tax rate on goods; you could simply tax household purchase of exempt services and goods; there is an increase in honesty in businesses when reporting services used; and you could reduce sales tax evasion.

The method in which a state chooses to expand taxes to services is also of great importance, could be implemented in one of two ways.

First, a comprehensive expansion of sales taxes to services. This would define all services as taxable unless explicitly exempt (mirroring the language for Sales of Goods). This manner would highly increase revenue gain, eliminate the need to revisit sales taxes as new services are invented, and reduce enforcement and administrative issues. Although this method would also immediately bring in thousands of new vendors, encompassing that many services would undoubtedly result in heavy lobbying for exemptions.

The second method is an incremental expansion of sales taxes to services. This manner would enumerate the added services taxed and would define retail sale. This would inherently require deliberate consideration of all aspects for each service, permitting a

[129] "Policy Basics: State Earned Income Tax Credits," Center on Budget and Policy Priorities. Referred to by Michael Mazerov, Senior Fellow, Center on Budget and Policy Priorities in his paper: Expanding Sales Taxation of Services: Options and Issues, 21.

balance of distribution, administration, and enforcement. Some issues with this method are that this could be a highly political issue, it would create only modest revenue gains, it would reveal a potential problem for every new service invented causing the issue to be constantly revisited and it would be difficult to write clear definitions of services.[130]

Talmadge Heflin, with the Texas Public Policy Foundation (TPPF), also presented testimony about expanding the sales tax to services during the hearing. In concept, he doesn't disagree with Mr. Mazerov's opinion. Mr. Heflin thinks a sales tax should be as broad as possible and have a rate as low as possible. When looking at the taxation of services and the exemptions or exclusions, it should be done in a comprehensive manner in order to avoid any unintended windfalls for the state or local municipalities. TPPF believes that broadening the base of the sales tax and lowering the rate will spawn economic growth significantly, resulting in several hundred thousand new jobs and a personal income growth in billions of dollars. While TPPF feels that an expansion of the sales tax base would provide significant economic growth, they feel Texas would benefit more by eliminating the property tax with that expansion.[131]

No matter what, if any, change is made to the current tax structure, TPPF believes that there should be a full public debate so people can give more comprehensive input, resulting in a policy that will promote the economy of the state.[132]

The Ways and Means Committee reviewed in a public hearing each of the different services discussed below. Each exclusion has an estimated value as provided by the Comptroller's Office. Also included is any input provided by witnesses regarding the merits of maintaining exclusion from taxation.

Certain Sales Tax Exclusions

The Comptroller's Office stated its concern regarding implementing a sales tax on service is limited to an ability to administer such a tax. Employees would have to spend time with each industry to better understand components they used, what they pay tax on, and how the tax would apply. The Comptroller's Office also stated that since some services are already taxable, the agency has experience in how to administer a service tax. They do have concerns, however, regarding the capacity to administer the tax since it would require additional agency staff and systems capacity increases. Any ratio regarding agency staff to industry is currently undeterminable and would likely vary from industry to industry.[133] Lastly, the Comptroller's Office states that any estimates regarding the costs to the state of services excluded from the sales tax are purely speculative since they do not assess a tax on these businesses entities and do not audit them for sales tax activity. Administrative costs would not necessarily match up with any fiscal note created for a potential bill.[134]

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[130] Dick Lavine, presenting PowerPoint *Sales Taxation of Services: Options and Issues* by Michael Mazerov.
[131] Oral Testimony presented by Talmadge Heflin with the Texas Public Policy Foundation to the Ways & Means Committee on March 25, 2010.
[132] *Id.*
[133] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[134] Testimony, John Heleman, Texas Comptroller's Office, March 25, 2010.

In order to assist the Committee with evaluating sales tax exemptions and exclusions, a memo was distributed requesting that witnesses shape their testimony by including information that would address the following questions:

1. Are you aware of any legislative history regarding the original purpose for exempting or excluding your industry from taxation?

2. What unique public policy purpose is served by maintaining the sales tax exclusion to your industry?

3. Is it inequitable to apply the sales tax to other goods and services, but not yours?

4. What specific tax administrative issues or costs exist in collecting the sales tax and remitting it to the state?

5. Does your industry use any other services as an input in the production process of your service?

Whether a witness discussed other issues, the answers to these questions made up a significant part of the testimony.

Elective and cosmetic physician and dental medical services

Elective medical services

The Comptroller's Office stated that there is currently only one other state, New Jersey, that taxes these kinds of services and has done so since 2004 as a 6% gross receipts tax. Included in the tax base are cosmetic hair transplants, cosmetic soft tissue fillers, skin resurfacing, laser treatments of leg veins, etc. With regard to procedures that could be considered both medical and elective, the Comptroller's Office states that New Jersey's list appears to be one that is most likely considered cosmetic.[135]

The Comptroller's Office estimates the exclusion of physician services in general is valued at $879.9 million in FY 2009 and $903.5 million in FY 2010. The general dental services exclusion is valued at $301.4 million in FY 2009 and $312.1 in FY 2010. It states that values specific to elective physician and dental services cannot be determined without guidance from the Legislature as to what procedures would be defined as elective.[136]

The Committee received testimony on behalf of the Texas Medical Association and the Texas Society of Plastic Surgeons from Dr. Bryan Pruitt. Dr. Pruitt argued that taxing medical services, in particular elective procedures, will create several problems such as a difficult and costly administration by the state, difficultly in determining what services are elective and taxable, and would intrude on patients' privacy since auditing will require reviewing private and

[135] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[136] Testimony, John Heleman, Texas Comptroller's Office, March 25, 2010.

sensitive patient medical records.[137]

Dr. Pruitt argued, with regard to medical services in general, that there are many unique features to the health care finance system that would create administrative difficulties in compliance. These difficulties might produce compliance-related costs that would exceed the value of the tax revenue. Some of the challenges in administering the tax on medical services in general are as follows:

- Physician at the time of the patient's visit may not know what fees will be paid given governmental and health plans contract fee limits, therefore determining the amount of sales tax cannot be calculated when traditionally done so;

- Even if the amount of the fee where determined and collected, subsequent adjustments and refunds would follow changing the amount of the fee;

- An uncertainty exists whether the insurer or patient pays for the sales tax; and,

- Even if Medicare and Medicaid services are exempt, a tax could be levied on coinsurance and deductibles.[138]

Dr. Pruitt stated that tracking and accounting for all these variables and the subsequent collections or liabilities would increase the cost of medical care due to the need for additional employees and costly new software systems for all physician offices. He also points out that the state would be faced by similar difficulties in its auditing and enforcement efforts.[139]

With regard to elective procedures, Dr. Pruitt defined these as procedures directed at improving the appearance but not the function of the body. That said, he stated that there is not a clear definition between a cosmetic procedure and one that treats illnesses, diseases, or malformation. For example, he stated that an identical procedure on two different patients could be determined as cosmetic in one and functional for the other. There are surgeries that have a mixed purpose or result that would pose a challenge for the determination of taxability. Dr. Pruitt provided various examples that he argues would be difficult to determine if cosmetic or medically needed, some but not all are included below:

- Newborn circumcision is considered by some payers as cosmetic but covered as a medical necessity by others, moreover the research is inconclusive as to the existence of any health benefits.

- Removal of moles or other skin lesions are often considered cosmetic, but a subsequent pathology may reveal melanoma or other skin cancer. This would create an issue if collection of the tax is at the time of service.

[137] Written testimony and oral testimony by Dr. Bryan Pruitt, Texas Medical Association and the Texas Society of Plastic Surgeons, House Committee on Ways and Means, March 25, 2010.
[138] *Id.*
[139] *Id.*

- Nose surgery or Rhinoplasty has a dual purpose since it is often performed to improve appearance but can also serve to improve breathing. For example, surgery to repair a broken nose, to straighten the bone or septum, has the dual result of function and appearance. It would be difficult in one operation to determine the percentage that is for function and how much was for appearance.

- Tummy tucks or abdominoplasty, after pregnancy or weight loss may be considered cosmetic, but excision of large tummy aprons of skin performed after significant weight loss may have a functional benefit since the excess skin can interfere with personal hygiene or may cause irritation or fungal infection.

- Upper lid blepharosplasty, which is the removal of excess skin in the upper lid may hang over and partially obstruct vision. Surgery would be performed to improve vision and appearance. Insurance companies have their own definition regarding how much obstruction qualifies for coverage. It would be difficult again to determine the percentage that applies to each.[140]

Dr. Pruitt argues that in order to determine taxability, a thorough examination of a patient's records is necessary, although doing so might not provide any certainty. In order to ensure compliance, an audit by the state would require reviewing private medical records and having staff review complex medical necessity decisions. Additionally, the state would need to provide additional extensive training to state auditors. Dr. Pruitt also argues that enacting a sales tax would also result in patients crossing state lines to avoid the additional costs. Dr. Pruitt stated that even if elective procedures could be isolated and a tax administered, he would have concerns that in the long run it would create a possibility of taxing all medical services.[141]

Elective dental services

Arguments by proponents of maintaining the sales tax exclusion on dental services mirrors those of physician services regarding problems in determining what constitutes "cosmetic" or "elective", mixed-procedures that are both cosmetic and necessary, and the potential challenges administration of a sales tax would create. There are some procedures that serve an orthopedic function but may be perceived as elective, for example the use of Botox to relieve jaw joint and muscle disorders.[142] Proponents argue that given the economic downturn and increasing medical costs additional taxes would only exacerbate the decrease in the number of individuals seeking preventative or necessary dental care.[143] As support for their argument, they state that studies show that currently only 61% of Texans report visiting a the dentist in a prior year.[144] Not only would the sales tax raise the price of services but compliance costs would also raise prices.[145]

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[140] *Id*.
[141] *Id*.
[142] Written testimony submitted on behalf of the Texas Academy of General Dentistry, House Committee on Ways and Means, March 25, 2010.
[143] Testimony by David May, Texas Dental Association, House Committee on Ways and Means, March 25, 2010.
[144] Written testimony, Texas Academy of General Dentistry, March 25, 2010.
[145] Testimony, David May, Texas Dental Association, March 25, 2010.

The Comptroller's Office estimate does not distinguish between elective and non-elective procedures and is based solely on general dental services. Any specific figures would require legislative guidance regarding the definition of "elective".

Non-financial legal services

The Comptroller's Office states that there are not many states that tax legal services.[146] South Dakota assesses a 4% line item gross receipts tax, that includes legal service and additional fees charged by the attorney however it is still administered as a sales tax.[147] The Comptroller's Office estimates the value of the exclusion of legal services as a general category, thus included are services performed beyond those services provided by licensed attorneys. The revenue losses are as follows:

2009	$447.3 million
2010	$458.8 million
2011	$472.5 million
2012	$489.1 million
2013	$504.7 million
2014	$521.7 million

The Law Firm Legislative Coalition presented written testimony stating that if the Legislature imposed new and/or increased state taxes it recommended that the additional tax burden be fairly apportioned among all sectors of the economy, including businesses and individuals; and that any change in the tax system not place Texas businesses at a competitive disadvantage.[148]

Accounting, auditing, and financial legal services

The Comptroller's Office estimates the cost to the state of excluding accounting and auditing services as follows:

2009	$201.8 million
2010	$213.9 million
2011	$226.6 million
2012	$240.5 million
2013	$254.2 million
2014	$268.4 million

The Committee received testimony from the Texas Society of Certified Public Accountant, (TSCPA), which stated that the sales tax is a tax on consumption, and therefore should not be levied on accounting services and the like because those services are primarily purchased by businesses as a means of production. Additionally, TSCPA argues that accounting services are

[146] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[147] Testimony, Robin Corrigan, Texas Comptroller's Office, March 25, 2010.
[148] Written testimony by the Law Firm Legislative Coalition, dated March 25, 2010.

sought out of a necessity to comply with the law. For example, given the complexity of tax law, many individuals and business must seek the assistance of a professional in tax preparation. Taxing accounting services would result in paying a tax on a tax.[149]

A sales tax on accounting services would result in fewer correctly filed returns, which could impact revenue collections. Given the nature of the technology and the nature of the service, accounting services can be offered remotely from any location and out-of-state accounting professionals, having no nexus and thus are not taxed, would have an unfair advantage against those professionals within the state. Collecting and remitting a sales tax would create a disincentive for professional service businesses to relocate to Texas. TSCPA points out that other states have also considered enacting a tax on professional services only to subsequently repealing the legislation due to a negative impact on the perspective state's economy.[150]

Architectural and engineering services

There are very few states that tax these types of services, but those that do assess it as a sales tax. South Dakota implements its tax as a gross receipts tax, but administered as a sales tax.[151] The Comptroller's Office estimates the loss of revenue to the state from architectural and engineering services as follows:

2009	$343.9 million
2010	$366.2 million
2011	$390.3 million
2012	$415.4 million
2013	$438.9 million
2014	$453.8 million

Several industry groups submitted testimony to the Committee in support of maintaining the sales tax exclusion on architectural and engineering services. The position of the Texas Society of Architects, (TSA), is that the exclusion is necessary for construction related firms, and the construction industry is vital to the state's economy. Because many significant projects cannot be built without architectural plans and specifications, the services are the first step to any construction development. Additionally, architectural design is usually the catalyst to employ other design professionals and construction related personnel. As evidence, TSA points out that according to the Bureau of Labor and Statistics indicates that there are potentially 30 jobs created for every design.[152]

TSA argues that as much as 50% of the fees paid to an architect are passed through dollars that

[149] Written and Oral testimony, Ira Lipstet, Texas Society of CPA's, House Committee on Ways and Means, March 25, 2010; *see also* memo to House Ways and Means Committee, Sales Taxes on accounting, auditing and other professional services, dated March 25, 2010.
[150] *Id*.
[151] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[152] Written testimony, Texas Society of Architects, Submitted to House Ways and Means Committee On Sales Tax Exemption for Architectural Services, Yvonne Castillo, TSA General Counsel, dated March 25, 2010.

go to the many sub-consultants employed. Because architects are often the 'top of the pyramid', there is a concern that a pyramiding of the sales tax could occur if sub-consultants services are also taxable.

With regard to administration, TSA points out that unlike traditional retail purchases, design contracts are not typically paid in a single transaction. Trying to determine when a tax is due, when the contract is made or when the project is finished might prove difficult. TSA states that construction costs are often lower than estimated, and those situations could require a refund of taxes. Like many other services, TSA argues architectural services have become a national, if not an international practice, and design projects in Texas can be provided by firms outside the state, which would remain untaxed. Smaller firms would bear a disproportionate burden of a new tax since they typically only do business in Texas and rely on local businesses.[153]

The Texas Council of Engineering Companies, (TCEC), argues eliminating the exclusion would send business out of state. It acknowledges that some knowledge of local conditions and regulatory restrictions is necessary, but due to technology actual design activities and consultation can be provided anywhere. While it is already common for many in the design community to be located in different states if not countries, it is also common for larger firms to move design activities to other states for reasons of workflow management or expertise. TCEC argues that these underlying motives would be exacerbated, and negatively impact Texas Jobs.[154]

Much like the architecture firms discussed previously, timing is an issue in collecting the sales tax since fees are not paid when services are contracted. Along the same lines, TCEC too has many parties and tiers of subcontractors that would create an administrative issue in determining the applicable tax.[155]

Regarding equity, TCEC argues that consideration cannot be separated from tax efficiency and administrative difficulties as discussed above. It states that the changes in the revised franchise tax already increased the state tax burden of most engineering firms. Many engineering firms were not taxed under the old franchise tax. Florida and Massachusetts passed a sales tax on some services, then repealed as administration grew too complex. TCEC states that more than half of engineering services are provided to governments that are tax exempt and therefore the potential for revenue is limited.[156]

The Texas Institute of Building Design's (TIBD) members provide comprehensive specifications containing drawings and written directions to clients. Services focus on residential design, small commercial structures, and remodeling projects. TIBD primarily supports the exclusion because it decreases costs of new construction. Increased costs could result in an inability to attain home ownership or limit the amount of house a consumer can purchase for their money. Higher cost may result in purchasing homes in areas further from a consumers' place of employment thus putting an increase burden on city and county services, infrastructure and the environment.

[153] *Id*.
[154] Written testimony, submitted by the Texas Council of Engineering Companies, dated March 23, 2010.
[155] *Id*.
[156] *Id*.

Higher costs would also impact the cost of remodeling projects that serve to enhance the value of existing homes.[157]

TIBD points out that the current economic downturn has had a particularly stressful impact on construction-related trades and removing the exclusion would hinder the industry further. Lastly, they point out that most building related firms are small companies that have 10 or fewer employees or are one-person firms.[158]

Management consulting and public relations

Only one state, Connecticut, taxes management consulting services, except when those services are provided to governmental entities, and does so as a sales tax. In Texas there are some consultation services that are taxed but only if the service results in the purchase of a taxable item. For example if an entity receives consultation and evaluation of computer system which leads to an actual sale then the consultation would be considered part of actual sale. There was no discussion as to how the value of the consultation is assessed in the final sale.[159]

The Comptroller's Office estimates the value of this exclusion as follows:

2009	$174.6 million
2010	$187.5 million
2011	$200.7 million
2012	$210.0 million
2013	$216.5 million
2014	$224.2 million

The Committee did not receive testimony regarding the benefits of this exclusion.

Research and development laboratory services

Research and development is very broad and is associated with many products, services, or technologies. It can range from consumer product development to military weapons systems.[160]

The Comptroller's Office estimates the revenue loss as follows:

2009	$134.5 million
2010	$138.0 million
2011	$142.1 million
2012	$147.1 million
2013	$151.8 million
2014	$156.9 million

[157] Written testimony, submitted by the Texas Institute of Building Design, dated March 25, 2010.
[158] *Id*.
[159] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[160] *Id*.

The Committee did not receive testimony regarding the benefits of excluding this service.

Economic and sociological research

The Comptroller's Office was unaware of any other state that taxes this service.

Estimated revenue loss excluding the service is as follows:

2009	$21.8 million
2010	$22.3 million
2011	$23.0 million
2012	$23.8 million
2013	$24.6 million
2014	$25.4 million

The Committee did not receive testimony regarding the exclusion of this service.

Non-clinical testing labs

The non-medical testing for cosmetic products and chemical testing for quality, is excluded from the sales tax. States that tax this service include Hawaii, New Mexico, Wisconsin, Washington, Virginia and Iowa.[161]

The Comptroller's Office estimates the value of excluding testing labs generally is estimated as follows:

2009	$52.2 million
2010	$53.6 million
2011	$55.2 million
2012	$57.1 million
2013	$58.9 million
2014	$60.9 million

The Committee did not receive testimony regarding the benefits of this exclusion.

Billboard advertising

Advertising space including newspapers, magazines, and the Internet is not subject to the sales tax. The Committee focused solely on billboard advertising because the *Tax Exemptions & Tax Incidence Report* listed it as an item. This type of advertising comprises a very small segment of advertising in general.[162]
The Comptroller's Office has estimated the loss of revenue to the state from the exclusion of

[161] *Id.*
[162] *Id.*

billboard advertisement as follows:

2009	$25.8 million
2010	$26.6 million
2011	$28.5 million
2012	$30.6 million
2013	$32.6 million
2014	$34.7 million

Several groups on behalf of the advertising industry submitted testimony on favor of retaining the exclusion from the sales tax. The Outdoor Advertising Association of Texas (AODAT) argues that sales taxes are generally levied on finished goods and that it considers advertising part of the manufacturing process. AODAT contends that advertising is an important tool for businesses trying to expand consumer base, showcase new products, or compete with other similar businesses. Advertising, the Association argues, is what generates sales and higher advertising costs would result in fewer sales and thus less sales tax related revenue.[163]

AODAT argues that reduced sales can occur because advertising and its related costs is part of getting a product sold. With higher advertising costs, final products cost more; moreover less advertisement means less competition and fewer sales. Additionally, taxing advertisement results in tax pyramiding since the billboard companies pass the tax to the advertiser who adds it to the taxes they pass to the consumer. AODAT also points out that taxing advertisements would result in neighboring states enjoying an increase in sales since advertisers near the state's border can simply move their spending to those tax-free states. Small businesses would be disproportionally impacted since they rely more heavily on outdoor advertisement.

Solely taxing billboards would create an unfair advantage for other advertising media such as newspapers. AODAT argues the only difference between the two is the size of the font. AODAT points out that taxing advertising has been tried unsuccessfully before. In 1986 Florida passed a sales tax only to rescind it in a special session of the legislature after the state saw a decrease in advertising while an increase occurred nationwide.[164]

CBS Outdoor Inc. (CBS) testified that solely taxing billboards would be unfair since other media such as newspapers, radio, television, internet, magazines, and mailers contain a large amount of advertisement, and create an un-level playing field. It points out that a pyramiding of taxes would occur since advertisement costs are passed on to end products. Additionally, a tax on advertisement would result in an economic disturbance. Advertising as a sales tool has a multiplier effect, and more would be lost from sales in comparison to the revenue collected from the tax. Advertisement creates competition and that a reduction in advertisement due to increased costs would also reduced competition. Lastly, CBS states that Texas has weathered the economic downturn better than other states, partly because of the attractive business climate.

[163] Written and oral testimony by Tim Anderson, Outdoor Advertising Association, March 25, 2010; *see also* "A Sales Tax on Outdoor Advertising?", That's No Way to Treat a Business", submitted by the Outdoor Advertising Association of Texas, dated March 25, 2010.
[164] *Id.*

Increasing advertisement costs would send an anti business message and may turn business away from Texas.[165]

Several organizations from the travel, hospitality, and entertainment industries, also submitted combined written testimony in support of the sales tax exclusion for billboard advertising. Although not representing the advertising industry, they argue that the hospitality and entertainment segments of the state's economy rely extensively on the use of billboard advertisement to inform the traveling public about their location. They, like the previous two groups, state that advertisement is not an end product and that a tax on billboard results in a pyramiding of taxes on retail consumers.[166]

Employment agency services and Temporary labor supply

Employment and staffing services are taxed in several states including, Hawaii, New Mexico, Washington, Virginia, Connecticut, South Dakota, and Washington, D.C.[167] The Comptroller's Office addressed these exclusions together since both offer temporary workforce and replacement workers. In Texas there are some instances where such labor is indirectly taxed, for example, hiring a temporary worker to perform a taxable services such as landscaping.[168]

The Comptroller's Office estimates the value of the employment agency services exclusion as follows:

2009	$31.5 million
2010	$33.8 million
2011	$36.2 million
2012	$37.9 million
2013	$39.1 million
2014	$40.5 million

Below are the Comptroller's Office's estimates the temporary exclusion costs the state:

2009	$46.7 million
2010	$50.5 million
2011	$54.4 million
2012	$57.2 million
2013	$59.1 million
2014	$61.4 million

[165] Written testimony, letter to The Honorable Rene Oliveira, Chairman House Ways & Means Committee, Re: Consideration of removal of sales tax exemption on billboard advertising, dated March 24, 2010.
[166] Written testimony, letter to The Honorable Rene Oliveira, Chairman Ways & Means Committee and Committee Members, Re: Consideration of removal of sales tax exemption on billboard advertising dated March 25, 2010; submitted jointly by Texas Hotel and Lodging Association, Texas Travel Industry Association, Texas Association of Campground Owners, and Texas Restaurant Association.
[167] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[168] *Id*.

The industry offers individual workers or groups of workers to businesses for temporary assignments under contracts, which cover the workers' salaries, payroll taxes, workers' compensation benefits, and their administrative fees. Often, businesses use temporary staffing services to fill in gaps, seasonal surges, medical leaves, or in meeting a special project requirement.[169]

The Committee received testimony from Career Consultants Staffing Services, Inc., (CCSSI), on behalf of the Texas Association of Staffing, supporting the exclusion of the sales tax on this type of industry. Increases of the cost to businesses hiring temporary workers would reduce total employment, personal income, and the state's overall economy. Staffing companies in Texas employed 880,551 individuals, and of those employees 312,906 bridged to permanent jobs in 2008. CCSSI argues that not only do they broker the placement of temporary labor, but also train individuals to give them the skills that make them more employable. CCSSI trains individuals that are relying on the state and/or federal economic assistance, and with that training, companies like CCSSI is assisting in moving these workers to full-time jobs. According to CCSSI the exclusion keeps labor cost low and Texans working.[170]

CCSSI also points out that a sales tax is regressive in nature, and thus when originally enacted, the state took care to protect working families by not taxing items such as food, water, and medicine. In keeping with that policy, CCSSI asserts that the state chose not to tax labor.[171]

CCSSI also argues that labor should be considered a production item since it is used to produce a final product. Doing so would result in the tax pyramiding a product. Additionally, they argue that imposing a sales tax would be equivalent to imposing a wage tax or personal income tax on the workers. Administrative issues exist in trying to tax only the service and not the wages and benefits.[172]

Financial services brokerage & Other financial

The Comptroller's Office was only able to find one type of financial services brokerage fee taxed in other states; loan broker fees, which are subject to taxation in Hawaii and South Dakota.[173] In the category of other financial, debt counseling and investment counseling were taxed in New Mexico, Iowa, and Connecticut and a very few other states. Banking service fees were taxed in Iowa, New Mexico, and Washington. The Comptroller's Office pointed out that automated banking services, such as ATM access, are already taxed since they constitute data processing fees that are the partially exempted as previously referenced.[174]

Below are the two estimates by the Comptroller's Office regarding the loss of revenue to the state:

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[169] *Id*.
[170] Written and oral testimony of Pamela Bratton, Career Consultants Staffing Career Consultants Staffing Services, Inc., testifying on behalf of the Texas Association of Staffing, dated March 25, 2010.
[171] *Id*.
[172] *Id*.
[173] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[174] *Id*.

Financial services brokerage

2009	$143.8 million
2010	$158.5 million
2011	$175.5 million
2012	$189.3 million
2013	$201.3 million
2014	$210.6 million

Other financial

2009	$61.1 million
2010	$66.1 million
2011	$71.4 million
2012	$76.2 million
2013	$80.9 million
2014	$85.2 million

Although these two items are calculated separately with regard to revenue loss, businesses often offer both services. Financial institutions offer a plethora of services to both business and consumers. The Independent Bankers Association of Texas (IBAT) testified that it will be challenging to define which financial services should be subject to a sales tax. For example, should the tax be assessed on retail and/or commercial transactions and would the tax be applied solely to fees or the interest charged as well? If interest were excluded from the sales tax, banks would restructure loans in order to reduce fees by increasing interest. Others ways to avoid the tax would have out-of-state banks close a large transaction or parties to a large transaction could merely opt to choose an out of state bank. Either choice would negatively impact in-state banks.

Additionally, with the spread of the Internet, IBAT points out that numerous financial institutions gather and make loans exclusively online. Presuming that most of these are not located in Texas, these financial institutions would operate without collecting the sales tax. Federal credit unions are exempt from paying any state taxes, including sales tax, and that the federal exemption would extend to their members. From an economic perspective, IBAT argues that a sales tax would only increase the cost of credit, which is needed in order to stimulate the economy. [175]

As for residential mortgage transactions, IBAT states that the purchase of a home involves a variety of fees and includes the services of many professionals, including appraiser, surveyor, title company, lawyer, mortgage originator, and loan purchaser. A tax on mortgage brokerage services would potentially impact all these participants. Maintaining the exclusion for mortgages will keep homes affordable.[176]

[175] Written and Oral testimony by Karen Neeley, Independent Bankers Association of Texas, House Committee on Ways and Means, March 25, 2010; written testimony dated March 24, 2010.
[176] *Id.*

IBAT states that many community banks are consumers of financial services and would be burdened with the tax since they are too small to employ in-house staff. They state that these services are required in order to comply with federal laws, therefore a sales tax would increase the cost of doing business, which would be passed on to customers. Texas banks would be less competitive.

Administrative issues would be logistically challenging. IBAT states that sufficient time will be needed for data processors to upgrade their programming in order to calculate and collect a sales tax. Some transactions will be logistically even more challenging to calculate, such as fees on ATM transactions. Some banks do not charge fees for use of ATM transactions on proprietary equipment, but do so when a customer uses the ATM of another financial institution. Some financial institutions refund ATM fees incurred by customers who meet certain criteria and use foreign ATMs. These types of varied transactions add a further challenge in calculating the sales tax.[177]

Real estate brokerage and agency

Real estate management, property sale agent fees, and abstract services are taxed in other states, like Hawaii, New Mexico, South Dakota, and Washington.

The Comptroller's Office estimates values of the exclusion as follows:

2009	$201.1 million
2010	$218.5 million
2011	$236.7 million
2012	$253.5 million
2013	$269.6 million
2014	$284.6 million

The Texas Association of Realtors, (TAR) argued the exclusion of real estate related services aids home sales and purchases across the state. The exclusion lowers home purchasing costs and makes acquiring homeownership much more obtainable.[178]

Other transportation (excluding scheduled passenger) intrastate transport: taxi, limousine, tour bus, and courier service

All transportation that is not scheduled passenger travel, including taxis, limousine, tour bus and courier services are excluded from sales taxes. The focus is on recreational or tourist oriented travel, excluding commuter travel and all air travel. The Comptroller's Office states that several states do tax either non-scheduled passenger transport and/or courier services. In Texas, tax collections could only occur on intrastate transportation, because the federal government has jurisdiction over interstate travel.[179]

[177] *Id.*
[178] Testimony by Joe Stewart, Texas Association of Realtors, March 25, 2010.
[179] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.

The Comptroller's Office estimates that the loss to the state for other transportation (except scheduled passenger) is as follows:

2009	$24.7 million
2010	$26.2 million
2011	$27.7 million
2012	$29.4 million
2013	$31.1 million
2014	$32.8 million

Testimony presented noted that tour bus services add to the tax base by transporting individuals that stay in Texas hotels and spend money in our local communities.[180] Proponents of the exclusion argued that tour bus companies already pay sales and use taxes on the inputs required to produce this service. They said the exclusion decreases costs to consumers and that the industry is very price sensitive. They argue loss of the exclusion would only encourage out-of-state competitors who could provide an equivalent services at a lower price.[181]

As for courier services, the Texas Courier & Logistics Association (TCLA) point out that they participate with a multitude of services and serve as an intermediate link between businesses. The service is only part of providing a final product and should not be subject to a tax intended for final transactions. TCLA also states that calculating the tax will be challenging because some deliveries would be taxable and some, such as deliveries to a tax exempt entity, would not.[182]

Small animal veterinary services

The Committee focused specifically on small animal services since most of the large animals services are used for agricultural purposes. The Comptroller's Office stated that very few states assess a sales tax on this service. The Committee discussed concerns that large animal veterinarians are decreasing in number, which creates agricultural issues, and acknowledged that assessing an additional tax could be detrimental to any efforts to stop the trend.

The Comptroller's Office has calculated the estimated costs to the state for veterinary services in general and does not distinguish by size or type of animal treated, those estimates are as follows:

2009	$47.6 million
2010	$49.5 million
2011	$51.5 million
2012	$53.5 million
2013	$55.7 million
2014	$57.9 million

[180] Written testimony, letter to House Committee on Ways and Means, by the Texas Travel Industry Association, dated March 30, 2010.
[181] *Id*.
[182] Testimony by John Jackson, Texas Courier and Logistics Association, March 25, 2010.

The Committee did not receive testimony regarding the benefits of this exclusion.

Automotive maintenance and repair

In Texas automobile parts are taxed, but not the labor associated with repair. The Committee considered the services provided in the maintenance and repair of both new and used vehicles. Many states do tax auto repairs and several services related to vehicle maintenance such as car washes, rust proofing, undercoating, tire repair, and recapping.[183]

The Comptroller's Office estimates value of excluding automobile maintenance and repair as follows:

2009	$270.6 million
2010	$286.9 million
2011	$303.9 million
2012	$322.5 million
2013	$340.8 million
2014	$359.9 million

Estimates of the value of car washes are:

2009	$32.9 million
2010	$34.8 million
2011	$36.9 million
2012	$39.2 million
2013	$41.4 million
2014	$43.7 million

The Texas Automobile Dealers Association, (TADA) submitted testimony in support of excluding services related to maintenance and repair from taxation. Arguments in favor of the exclusion are based primarily on the necessity automobiles play in the daily life of working Texans. Proponents of the exclusion argue that the sale and servicing of vehicles is important since they provide a means for families to get to and from a job and at times are used in the performance of a job. It was noted that purchases of maintenance and repair services are not usually voluntary but rather necessary in order to keep the vehicle running and/or in good working condition. Older vehicles, which are usually owned by individuals of lower economic means, require more repairs than newer vehicles and as such, any tax would be regressive in nature. A safety issue could also arise out of eliminating the exclusion. Individuals would be less likely to repair their vehicles and therefore could result in a loss of safety and reliability in vehicles on state roads. TADA argues that the assessment of a sales tax would negatively impact automobile dealers since a significant component of their business activity lies in vehicle maintenance and repair. Raising the cost of the service would result in a loss of volume repairs and income. TADA asserts that the sale and service of motor vehicles already provide a

[183] Testimony, Bryant Lomax, Texas Comptroller's Office of Public Accounts, March 25, 2010.

considerable source of revenue for the state.[184]

Proponents also state that automobiles are already taxed multiple times, such as the initial sale, at every subsequent sale, and on a yearly basis when including motor vehicle registration fees.[185]

Travel arrangements

Travel arrangements are taxed in Hawaii, New Mexico, Utah, South Dakota, and Washington. Generally, Texas does not tax these services, but destination management companies that plan entire events such as conferences are taxed for the items used in providing the service.[186]

The Comptroller's Office estimates the costs to the states as follows:

2009	$13.8 million
2010	$14.7 million
2011	$15.5 million
2012	$16.5 million
2013	$17.4 million
2014	$18.4 million

The Committee did not receive testimony regarding the benefits of this exclusion.

Private vocational education

A survey of other states revealed that no states tax this service.[187]

The Comptroller's Office estimates the cost to the state as follows:

2009	$50.0 million
2010	$53.0 million
2011	$56.1 million
2012	$59.5 million
2013	$62.9 million
2014	$66.5 million

The Committee did not receive any testimony regarding the benefits of this exclusion.

[184] Written and oral testimony by Robert Braziel, Texas Automobile Dealers Association; *see also* Memorandum Chair, House Committee on Ways & Means, TADA response to the Committee's request for information regarding the sales tax exemption for labor services in motor vehicle repair, dated March 23, 2010.
[185] Testimony by Larry Cernosek, Texas Towing & Storage Association, March 25, 2010.
[186] Testimony, Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[187] *Id*.

Other educational services

Other educational services are education related to specific skills or occupations and excluded from taxation. Excluded from the definition are public education, K-12, whether it be public or private. Also excluded are all post-secondary institutions, public or private, and community colleges. There are very few states that tax these types of services.

The Comptroller's Office estimates the cost to the state of this exclusion as follows:

2009	$36.1 million
2010	$38.3 million
2011	$40.5 million
2012	$43.0 million
2013	$45.5 million
2014	$48.0 million

Providers of defensive driving courses support retaining the exclusion for taxation of other education services. They state that according to Title 5, Chapter 1001, Texas Education Code, that a driving training schools be treated in a manner that has the least possible economic effect on the schools. It is their position that adding a sales tax would run counter to this goal since the increase in the cost of their program would result in fewer drivers opting to take defensive driving.[188]

Section 1001.003, Education Code, says that:

> "It is the intent of the Legislature that agency rules that affect driver training schools that qualify as small business be adopted and administered so as to have the least possible adverse economic effect on the schools."

The Tax Code is certainly not an agency rule adopted by the Texas Education Agency. Thus, Section 1001.003, Education Code, has no application regarding the exclusion from taxation.

Proponents further assert that an increase in the cost of defensive driving services would disproportionately impact drivers of lower economic means, negating alternatives to paying fines and higher consumer rates. Driver safety schools already pay a licensing fee to the state in addition to the sales tax made on their purchases.[189]

Interior design

While interior design services are not taxed, all the items purchased by interior designers, such as furniture, paint, artwork are taxable. The creative element of design is not subject to the sales tax. This service is taxed in a few states, Alaska, Hawaii, South Dakota, Virginia, and Washington to name a few.[190]

[188] Written testimony, letter to The Honorable Rene Oliveira from DefensiveDriving.com, dated March 25, 2010.
[189] *Id*.
[190] Bryant Lomax, Texas Comptroller's Office, March 25, 2010.

The Comptroller's Office estimates the value of the exclusion as follows:

2009	$8.8 million
2010	$8.9 million
2011	$9.1 million
2012	$9.2 million
2013	$9.3 million
2014	$9.5 million

The Committee did not receive testimony regarding the benefits of this exclusion.

Personal services: tattooing, tanning, and body piercing

There are no specific cost estimates available for these types of services. Tattooing is taxed in several states, as is tanning, and there was no evidence of other states that tax body piercing.

The Committee received testimony on behalf of the Indoor Tanning Association, (ITA). ITA supports maintaining exclusion for sales tax on services, specifically tanning services. ITA's position is that the tanning industry is presently bearing a larger than normal tax burden given the recent state and federal actions. The health care reform legislation placed a 10 percent federal sales tax on indoor tanning. ITA states that the recent revision of the state's franchise tax resulted in a disproportionally negative impact on the tanning industry since as a service their industry must pay the higher one-percent margin tax rate and is eligible for only minimal deductions.[191]

ITA states that in recently years the tax burden has increased dramatically and eliminating the exclusion would be just an additional measure to generate revenue from operators and consumers of tanning facilities. They state that most tanning facilities are small businesses that are already struggling from the present economic slowdown, and that an additional tax would push some of these businesses from being slightly profitable to unprofitable.[192]

ITA also points out that while tanning is a cosmetic procedure, there are other services that are also cosmetic and not subject to the sales tax. Singling out tanning, in their view, would be unfair and subjective.[193]

Water conditioning and water softening

These services are taxed in other states, but the Comptroller's Office has been unable to determine what is considered conditioning and softening.[194] There are also no figures available regarding the value of the exclusion.

[191] Written testimony, letter from John Overstreet, Executive Director, Indoor Tanning Association, dated March 25, 2010.
[192] *Id.*
[193] Bryant Lomax, Texas Comptroller's Office, March 25, 2010.
[194] *Id.*

The Committee heard no testimony regarding the benefits of this exclusion.

Severance Tax

Oil and Gas

Background

Severance taxes are assessed on companies or individual producers that extract or "sever" natural resources (such as oil and gas) from the land in order to make a profit. The severance tax is intended to compensate the state's present and future citizens for the loss of the natural resources. A severance tax may also encourage conservation and judicious usage of oil and gas.

In Texas, the severance tax is assessed on the oil or natural gas as it is sold at the wellhead. Severance taxes are reported and paid to the Texas Comptroller Office of Public Accounts and the Railroad Commission of Texas (Commission) maintains regulatory oversight and regulatory reporting. Each agency has individual responsibility for differing aspects of oil and gas extraction and reporting, however certain severance tax incentives may have dual filing requirements. Chapter 201 of the Texas Tax Code governs the imposition of taxes on the production of gas and any applicable exemptions, whereas Chapter 202 of the Tax Code governs the oil production tax and exemptions.

For low producing and high cost wells the amount of a tax may determine the difference between shutting in a well, keeping a well in production, or bringing a well back into production. Severance taxes are a factor in a producer's decision to drill a well, initiating an enhanced recovery project, or servicing a well to increase its production.

During the late 1980's the Texas Legislature created tax incentives to maintain the production of oil and gas in the state. The natural gas market was transitioning from a regulated environment to a deregulated one. Many operating wells had costs that made it economically unfeasible to operate in a free market environment. Incentives took the form of permanent and temporary tax exemptions and reductions of the severance tax on oil and gas production in order to lower the cost of production. Since the original creation of these tax incentives, subsequent legislatures have further refined or added additional incentive programs. For a history of the severance tax in Texas, please see Appendix D.

The current baseline severance tax on oil and gas is:

Gas Severance Tax = 7.5% of market value of gas produced and saved.
Oil Severance tax = 4.6% of market value of oil produced.
Condensate tax = 4.6% of market value.

There are several tax incentive programs for the oil and gas industry. These incentive programs take various forms of exemptions and reductions and include: Enhanced Oil Recovery, High-Cost Gas, Marketing of Previously Flared or Vented Casinghead Gas, Two-Year Inactive Well, Marginal Wells, Enhanced Efficiency Equipment Credit, and Orphaned Well Reduction.

Oil produced from an approved new enhanced oil recovery project or expansion of an existing project is eligible for a special tax rate of 2.3% of the production's market value (one-half of the standard rate) for 10 years after certification of production by the Commission. When expanding an existing project, the reduced rate is applied to the incremental increase in production after response certification. Gas from a well defined as high cost under §107 of the old Federal Natural Gas Policy Act is eligible for a severance tax reduction, the level being based upon drilling and completion costs. To qualify for the reduction a well must be spudded or completed after September 1, 1996.[195]

An exemption may be granted for the life of a well if the operator markets casinghead gas previously released into the air (either vented or flared) for a period of 12 months or more and does so in compliance with Commission rules and regulations.[196] If an oil or gas well has been inactive during the preceding two years, any new oil, gas well gas, or casinghead gas production may be eligible for a severance exemption of up to 10 years.[197]

Producers of marginal oil and gas wells are eligible for severance tax relief when oil and gas prices fall below certain levels. This tax incentive became effective on September 1, 2005. In the case of both marginal oil wells and marginal gas wells, three levels of tax credits exist on production from qualified low-producing wells for any given month, the level depending on the Comptroller's Office average taxable prices, adjusted to 2005 dollars, based on applicable price indices of the previous three months. The credit rates also vary depending on whether the marginal well is oil or gas. A qualifying low-producing gas well is defined as a well that averages over a three-month period, 90 mcf per day or less. An mcf is defined as 1,000 cubic feet of gas as measured by Section 91.052, Natural Resources Code. An oil well lease meets the low-producing definition if the lease averages over a 90-day period, less than 15 barrels per day per well or 5% recoverable oil per barrel of produced water per well. The tax credit is limited to only those wells currently paying full tax rates. Additionally, tax credits are not extended to casinghead gas and condensate production.[198]

Marginal oil wells that use equipment that reduces by 10% energy required to produce a barrel of fluid are eligible for the enhanced efficiency equipment credit, a severance tax credit. A marginal well is a well that produces 10 barrels of oil or less per day on average during a month. The credit is an amount equal to the lesser of either 10% of the cost of the equipment or $1,000 per well. The credit is approved by the Comptroller's Office, subject to evaluation of the equipment by an institution of higher education. Enhanced efficiency equipment installed in or on a qualifying marginal well must be purchased and installed no earlier than September 1, 2005.[199]

The Orphaned Well Reduction incentive can be claimed if a well has been inactive for 12 months where the operator of the well no longer has a current registration with the Commission as

[195] SB 963, 71R
[196] SB 1440, 75R
[197] Originally adopted SB 126, 75R, extended HB 2104, 76R
[198] Originally adopted HB 2161, 79R, made permanent HB 2982, 80R
[199] HB 2161, 79R

required by statute. The well is eligible for a program that allows a new operator to nominate the well and be given a 30-day period to inspect the well and determine if the operator wishes to assume operatorship of the well. To assume operatorship, a new operator must provide a good-faith claim to the right to produce minerals from the well. If an orphaned well is taken over by a new operator during the effective period, 1/1/06-12/31/07, the operator is entitled to receive a non-transferable exemption from taxation for all future production from the well, a non-transferable exemption from the fees paid into the Oil Field Cleanup Fund, and a payment from the Commission in an amount equal to the depth of the well times $.050/foot. To qualify for payment by the Commission, the operator must no later than the 3rd anniversary of the date the operator acquires the well, brings the well back into continuous active operation or plug the well in accordance with Commission rules.[200]

There are two other exemptions related to taxes other than the severance tax. They are the Reuse / Recycling of Hydraulic Fracturing Water tax exemption and the Advanced Clean Energy tax reduction. The Reuse / Recycling of Hydraulic Fracturing Water exemption applies to tangible personal property specifically used to process, reuse, or recycle waste water that will be used in hydraulic fracturing work performed at an oil or gas well. This property is exempt from sales, excise, and use taxes.[201] The Advanced Clean Energy tax rate reduction exists on oil produced from enhanced recovery projects using anthropogenic carbon dioxide (CO_2). To qualify, certification of CO_2 use in the enhanced recovery project must be obtained by either the Commission, the Texas Commission on Environmental Quality or both, depending on whether the project is to be sequestered in a reservoir productive of oil or natural gas, sequestered in a formation other than a reservoir productive of oil or natural gas, or is sequestered in both types of formations.

Texas is the leading oil and gas producing state in the nation. Oil production is 64% higher than Alaska, which is the second state, and gas production is 221% higher than Wyoming, the second state. According to the Texas Oil and Gas Association in 2008, the oil and gas industry paid $9.9 billion in Texas state and local taxes and royalties, which is over $50,000 per employee of the industry. The "rainy day fund", which is now over $7 billion, is financed primarily from oil and gas severance taxes.[202]

The House Committee on Ways & Means met on January 13, 2010 to discuss tax exemptions applicable to the oil and gas industry. The following details the testimony provided to the Committee during the public hearing.

Severance Tax Incentives

Over the past decade, enhanced oil recovery projects have generated an estimated $405 million in severance taxes based on a certified increase in production. The projects are typically large and involve water or CO_2 injection. High-cost gas production has nearly tripled during the past

[200] HB 2161, 79R
[201] §151.355, Tax Code, relating to Water Related Exemptions, HB 4, 80R
[202] Written testimony provided to the Ways & Means Committee by James LeBas with the Texas Oil and Gas Association on January 13, 2010.

decade, and accounts for 86% of the gain in Texas total production. From 1997 to 2009, natural gas price rose 135%. The cost of drilling and completing a certified high-cost well rose by 294%. Texas is more effective at both finding and producing from shale gas formations than other states, and these tax incentives help.[203] In order to take advantage of these tax incentives, The Texas Oil and Gas Association testified that the industry has to spend a lot of money and the economy benefits from this investment. Over a billion dollars a month goes into the state economy from these tax incentives.[204]

Doug Robinson, with the Texas Oil and Gas Association, testified that secondhand recovery is the present and future of the oil industry in Texas. He generally believes that Texas has a tax regulatory scheme that is working and no changes need to be made at this time. New technologies are the fruit of tax exemptions and policies and have helped Texas to maintain its role as a leader in the oil and gas industry. These incentives have spurred economic activity. Mr. Robinson also challenged the Legislature to preserve oil and gas from actions taken against the industry by the federal government.

Severance Tax Exemptions

Tad Mayfield, President of the Texas Independent Producers and Royalty Owners Association (TIPRO) testified that severance tax relief for marginal wells during periods of low prices and for wells previously inactive for two or more years will help to keep Texas wells producing. Many of the 5,000 independent producers in Texas are struggling. The rig count has dropped by more than half from the high of 946 rigs in September 2008 to 470 in December 2009. Producing Texas wells provide Texas energy, Texas jobs, ad valorem taxes for the local tax districts, sales taxes for the state, and provide additional state severance taxes when prices rise to more economic levels.[205] Severance tax exemptions help to keep the oil and gas industry afloat when the economy is struggling.

[203] *Id.*
[204] Testimony by James LeBas, Texas Oil and Gas Association, January 13, 2010.
[205] Written testimony provided to the Ways & Means Committee by Tad Mayfield, President of the Texas Independent Producers and Royalty Owners Association ("TIPRO") on January 13, 2010.

Value of Natural Gas Tax Exemptions[206]
Fiscal 2009 to 2014 - In millions of dollars

Tax Code Section	Exemption	2009	2010	2011	2012	2013	2014
201.057(c)	High-cost natural gas	$980.0	$861.0	$962.5	$1,081.2	$1,215.2	$1,374.3
201.058(a), 202.056	Wells previously inactive	71.1	62.2	69.2	77.3	86.5	97.3
201.058(a), 202.060	Orphan well program	*	*	*	*	*	*
201.058(b)	Flared/released gas	*	*	*	*	*	*
201.059	Low-producing gas wells	0.0	0.0	0.0	0.0	0.0	0.0
Total	Value of Natural Gas Exemptions	$1,051.1	$932.2	$1,031.7	$1,158.5	$1,301.7	$1,471.6

[206] The Table is reproduced from the *Tax Exemptions and Incidence Report.*

Minerals excluded from the Severance Tax

The Ways & Means Committee met on May 25, 2010 and heard testimony regarding minerals excluded from the severance tax. Specifically, the minerals considered by the Committee were: Asphalt, Basalt, Bleaching clay, Bromine, Caliche, Cement, Clay, Coal, Dolomite, Gemstones, Gypsum, Helium, Iron, Lignite, Lime, Magnesite, Magnesium, Salt, Sand and gravel, Sands, Stone-crushed, Stone-dimension, Sulfur, Talc, Uranium, and Zeolites.

The Comptroller's Office testified that two minerals are subject to a production tax in Texas: cement and sulfur. Cement is taxed 55 cents per ton or .0275% per 100 lbs. This tax is reported monthly and brings in approximately $9 million to the state annually. Sulfur is taxed $1.03 per long ton. This tax provides about $3 million in revenue annually. Besides these two minerals, all others listed above are currently exempt from the severance tax in their natural forms. If these minerals are processed or subject to any type of manipulation, they do become subject to the state sales tax.[207]

Testimony was not provided for all of the minerals, but the testimony that was received is detailed in this report

Coal and Lignite

The Energy Report, a special report issued by the Comptroller's Office, defines coal as a "combustible rock formed from prehistoric biomass". Like oil and natural gas, coal is considered a "fossil fuel" because it was formed from decaying plant material over hundreds of millions of years".[208] Currently, coal is one of the world's most widely used fuels, generating 39% of the world's electricity (present in 70 countries), 49% of U.S. electricity and 36.5% of Texas' electricity, as of 2006. During that same period, coal mining provided 2,241 jobs, earning an estimated $167.6 million in wages. Texas coal owners are not required to report their coal's value nor do they owe state taxes on coal production, unlike the oil and natural gas industries. In 2009, Texas electric generators consumed 95 million tons of coal. Approximately 1/3 of that was lignite and 2/3 was western coal.[209]

The Committee heard from several groups that oppose removing the exclusion from severance taxes on coal. Groups such as the Association of Electric Companies of Texas, Inc. (AECT) and the American Coalition for Clean Coal Electricity (ACCCE) believe that removing the exclusion on coal and lignite would negatively impact Texas consumers and the state's economic health. A tax on coal would most likely be passed through to consumers, increasing the cost of electricity bills. In 2009, 4.2 million Texas families, one-half of the state's population, spent an estimated

[207] Testimony, Bryant Lomax, Texas Comptroller's Office of Public Accounts, May 25, 2010.
[208] Energy Report issued by the Comptroller's Office of Public Accounts, May 2008: http://www.window.state.tx.us/specialrpt/energy/
[209] Oral Testimony provided to the Ways & Means Committee by Randy Eminger, American Coalition on Clean Coal Electricity, on May 25, 2010.

18% of their after-tax incomes on energy for residential use or gasoline, an amount equal to what usually is spent for housing, food and other major necessities.[210]

Removing the exclusion would also create an economic advantage for Texas' coal competitors, such as Wyoming, and make the state less competitive in a nationwide coal market. All of Texas' lignite production is consumed in Texas not shipped out of state. Eliminating the exclusion on production would be borne virtually 100 percent by Texans.

Proponents also argue that sound policy calls for taxes to be on final use of a product, such as a car being taxed at the dealership instead of the steel being taxed at an auto plant. The electricity should be taxed and not coal as an input to the manufacture of electricity.[211] The natural gas burned by some power plants is subject to severance taxes. Presumably, not taxing coal gives a competitive advantage to coal burning plants.

Some proponents of taxing coal production see that coal production could potentially provide a large source of revenue for the Texas economy. They argue that in addition to being excluded from the severance tax, the industry comparatively pays nothing in fees. It is important to note that coal also has extremely high environmental and public health consequences.

Nine out of the twelve other major coal-producing states have adopted some sort of severance, production, excise or other type of tax for coal production. Wyoming, the nation's largest coal producer, taxes coal through a severance tax ranging from 3.75 to 7.00 percent at point of valuation. When Texas power plants buy Wyoming coal, a portion of an individual's electricity payment is exported to finance Wyoming's state government. If Texas was to impose a coal tax like Kentucky, which is a tax on the percentage of coal as well as upon processing coal, it could generate up to $70 million per year. Ohio taxes coal at 11.2 cents per ton. A similar law in Texas would generate approximately $5 million per year.[212]

Proponents of eliminating the exclusion of coal from the severance tax propose three possible options to implement a coal tax:

1. A coal use tax that would tax each coal purchase at the rate of 7.5% (like natural gas) or 4.6% (like oil);

2. A coal production or severance tax that would tax coal mined; or

3. An energy efficiency tax that would tax coal power plants with a rate depending on the measures of pollution coming from a fossil fuel source.

To summarize, proponents of taxing coal believe that it is a huge potential source of revenue for the state. If taxed, Texas would simply join the ranks of most of the other large coal producing

[210] *Id.*
[211] Testimony provided by AECT, House Ways and Means Committee, May 25, 2010.
[212] Testimony provided by Cyrus Reed, Conservation Director, Lone Star Chapter, Sierra Club, House Ways and Means Committee, May 25, 2010.

states that tax coal production in various ways. Opponents of taxing coal believe this tax could not only be harmful for the industry, taking away a competitive advantage, and Texans, who would feel the brunt of the new tax.

The *Tax Exemptions and Tax Incidence Report* does not contain an estimate for the value of the exclusion of coal from the severance tax.

Charge 3

Study methods for improving the quality and uniformity of, and communications to taxpayers about, property tax appraisals.

Charge 6

Monitor the implementation of property tax appraisal and alternative valuation appeal reforms enacted by the 81st Legislature.

Charges 3 and 6 are both addressed in this section. There is considerably overlap between the two discussion areas. During the Ways & Means hearings conducted on these charges, witnesses generally testified on both topics simultaneously.

Background

During the Interim of the 80th Legislature, Speaker Tom Craddick appointed a Select Committee on Property Tax Relief and Appraisal Reform to research and examine the property tax system. They reported their findings and submitted their recommendations to the 81st Legislature. Many of the reforms enacted by the 81st Legislature stem from the findings of the Select Committee.[213]

The Select Committee discovered that appraisal review boards did not conduct appraisals uniformly or fairly across the state. Some appraisals were conducted every year, while some were conducted every other year. Taxpayers often did not know when appraisal review boards (ARB) would conduct the appraisal on their property. The Select Committee also found that appraisal review boards determined a property's appraisal value by considering its "highest and best use," meaning that a residential property could be appraised on the potential it has as a commercial property. This sometimes caused the property's appraisal value to increase by 200-400 percent in one year, even if the property was not used as what was considered its "highest and best use."

During committee hearings witnesses explained that the fair market value of their homestead increased substantially because appraisal review boards excluded recently foreclosed properties and properties with distressed resale value within the neighborhood. Whether appraisal review boards used the cost method, income method, or market data comparison method of appraisals, the authority to include or exclude neighboring foreclosures was unclear.

The Select Committee recommended that the 81st Legislature implement several changes to create more uniformity and fairness within the appraisal process. House Bill 8 was passed to increase the accuracy of and improve standards and practices of, property appraisals in Texas. This bill requires the Comptroller's Office to review the following every two years: Taxpayer assistance provided by central appraisal districts (CADs); appraisal district governance; operating and appraisal standard procedures and methodology; and make recommendations. The bill also created the Comptroller's Office's Property Value Study Advisory Committee and changed the school district property value studies to a biennial schedule.[214]

House Bill 8 also requires the Comptroller's Office to conduct an appraisal district methods and procedures review in one year and a traditional property value study in the year following to generate greater statewide uniformity. Harris County, which has already been through a thorough review, found it thorough and professional. The methods and procedures checklist helps every appraisal district benchmark and improve its programs.[215]

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[213] *Report of the House Select Committee on Property Tax Relief and Appraisal Reform* submitted to the 81st Legislature on December 1, 2008.

[214] Testimony by Deborah Cartwright, Director, Property Tax Assistance Division, Texas Comptroller's Office of Public Accounts, House Committee on Ways and Means, October 14, 2010.

[215] Testimony by Jim Robinson, Chief Appraiser, Harris County Appraisal District, House Ways and Means

In order to address the concerns about appraising a property at its "highest and best use" value, HB 3613 was passed requiring that the market value of a homestead be determined solely on the basis of the property's value as a homestead, regardless of whether the residential use of the property by the owner is considered to be the highest and best use of the property.[216]

Various counties implemented a local system to differentiate between the properties that were being used for residence and those that were being used for commercial. Harris County identified 10,139 residential homesteads that were mixed with commercial-use properties and revalued based on the new law. Overall, there has been a value reduction of approximately $5,000,000 for the tax year of 2010.[217] The changes have prevented many disputes.

To address the exclusion from appraisals of foreclosed properties and properties of distressed value, the Legislature passed HB 1038 which mandates that CADs may not exclude from appraisals property sold at foreclosure in any of the three years preceding or was comparable at the time of sale, or declined in value because of the economy.[218]

Harris County CAD is aware of approximately 40,000 sales that occurred between January 2009 and February 2010. Approximately 1/4 of these sales were foreclosures. As the CAD compared these properties, it found that many of the foreclosed properties were in significantly worse condition than the non-foreclosed properties. Neglectful or disgruntled former owners often caused the damage. While the CAD will consider the value of foreclosed property when evaluating other property, it also believes it is imperative to do so on an individual basis to ensure that damaged, foreclosed homes are not compared to undamaged homes. If such comparisons do occur, the result could be appraisals below fair market value.

The protest process for taxpayers who reappraised their property was also another consistent problem across the state. The appeals process is as follows: One begins with the an initial appeal to the appraisal review board. If this initial appeal is unsuccessful, the taxpayer appeals to district court, which decides whether the appraisal value remains at or decreases from its determined value. Even though a property owner successfully lowered the value of their property, often in the following year they still receive an initial value that is either the same or higher than the first valuation, even with little or no change on the property. The taxpayer had to endure the same protest process again, which took too much time, effort, and money. In response to this, SB 771 was passed. This bill expands binding arbitration as an alternative to judicial review. It also reduces the filling fee from $500 to $250 if the property owner agrees to an expedited hearing of two hours or less and increased the continuing education training requirements for arbitrators. A CAD is also prohibited from increasing the value of a property following a year that an ARB, arbitrator, or court determined its value, unless the CAD has substantial evidence to support an increase.

Furthermore, the Tax Code provides no guidance for appraising property under the market data

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Committee, October 14, 2010.
[216] *Id*.
[217] *Id*.
[218] *Id*.

comparison, which results in inconsistent and unpredictable systems for determining the property's value for property tax purposes. SB 771 also made changes to comparable sales. A sale may not be considered a comparable sale unless it occurred within 24 months of the appraisal date, unless enough properties did not sell during that period. Comparable sales must all be time-adjusted and comparability must be determined based on similarities in location, square footage, age, condition, and other factors.[219]

SB 771 also requires that the appraisal district must have "substantial evidence" to support increasing value if the value was reduced in the previous year. One concern about the implementation of this law by appraisal districts is that they do not have the resources to review every item about every property every year. They feel this could especially become a problem in raising values once the market turns around. One suggestion from Harris County is that the burden of proof language be clarified and aligned with existing burden of proof language. In order to decipher why a particular property's value changed from the previous year, the county created account flags such as: change in characteristics, new construction, repairs, and market data supports new value. A total of 47,879 Harris County accounts were affected by this change for tax year 2010.[220]

The Select Committee also concluded that taxpayers have lost confidence and trust in appraisal review boards because board members are appointed by the county appraisal district board of directors, who are appointed by the taxing entities within the CAD. This process encourages taxpayers' perception of bias within appraisal review boards. Many taxpayers testified that they felt mistreated and that ARBs made its decision in favor of the CAD before taxpayers had pleaded their case.[221]

The Legislature believed that the system would have to change in order to change the taxpayers' perception of appraisal review boards. The 81st Legislature passed several bills into law that created specific requirements for ARBs. House Bill 3611, authorizes the boards of directors in two or more adjoining appraisal districts to consolidate their ARBs by interlocal contract, believing this will create a greater talent pool of well-qualified and experienced individuals in low population areas. House Bill 2317, requires the Comptroller's Office to provide a continuing education course that trains appraisal review board members. This course addresses requirements on the independence of ARBs from the board of directors and chief appraiser, the appraisal methodology, and legal issues. House Bill 1030 requires that a local administrative judge appoints ARBs in certain counties (Harris and Fort Bend).[222]

The training for ARB members through classes provided by the Comptroller's Office per HB 2317 and the appointment of ARB members by the administrative state district judge per HB 1030 are working very well. In Harris County, the overall efficiency of the appraisal review board has improved significantly, though they face a challenge in the expense of operating a 175-

[219] *Id*.
[220] *Id*.
[221] *Report of the House Select Committee on Property Tax Relief and Appraisal Reform* submitted to the 81st Legislature on December 1, 2008.
[222] *Id*.

member body. The recommendation from Harris County is that the legislature consider allowing boards of directors to provide for auxiliary ARB members in large districts and to consider allowing ARB members to sit in single member panels.

Oil and Gas Property Valuation

During the 80th Legislature, Section 23.175 of the Tax Code was amended by House Bill 2982 to change the valuation formula for oil and gas properties. Previously, if an appraisal method took into account future income from a well, the average price of oil or gas for the preceding year was used as the price for the current year. When considering future income for succeeding years, the average price from the preceding year could be increased or decreased in those succeeding years for the purposes of the current year's appraisal. If the average price for the succeeding years was increased, the annual percentage rate of increase may not be greater than the rate increase projected by the Comptroller's Office for revenue estimating purposes. Under no circumstance could the increase exceed 150 percent of the current year's appraisal. No limits were placed on decreases.

House Bill 2982, 80th Legislative Session, changed the appraisal methodology to more directly tie values to the Comptroller's Office estimated price of oil and gas used for revenue estimating purposes. Under the new bill, the preceding year's price is multiplied by a "market condition factor." The factor is determined by the Comptroller's Office by dividing the estimated statewide average price forecasted for revenue estimating purposes by the preceding year's actual average price. Then the price for succeeding years shall reflect the same percentage rate increase or decrease.

In Elliot & Morris' Texas Tax Code Annotated, the authors offered this commentary on the amendment to Sec. 23.175 made by House Bill No. 2982:

> This amendment will cause the taxable values of oil or gas reserves in some counties to be set at values higher than would be set by using the true fair market value sales and will cause the taxable values in other counties to be set at values lower than would be set by using the true fair market values sales.[223]

The Texas Association of Counties (TAC) takes issue with this new methodology. TAC claims there was a severe underestimation for the actual price of crude oil in 2008 and 2009. If oil and gas property is undervalued there is a shift of the tax burden to other property owners and a loss of revenue to local governments.[224] It should be noted that the Legislative Budget Board anticipated a loss of state revenue at the time HB 2982 passed, but no loss was anticipated for local governments. The fiscal note for the bill showed a negative impact through the biennium ending July 31, 2009 of $1.1 billion dollars for the state.[225] Some counties feel that the change in methodology for calculating the valuation formula has created an even larger loss of revenue

[223] William D. Elliot and J. Scott Morris, Elliot & Morris' Texas Tax Code Annotated, (West, 2009), pg. 223
[224] Testimony by Texas Association of Counties and County Judges and Commissioners Association of Texas, House Committee on Ways and Means Committee, March 25, 2010.
[225] Fiscal Note for HB 2982, 80th Regular Session.

because the change has resulted in artificially low appraisals on oil reserves.

For the three years in which data is available, the Comptroller's Office's forecast has been significantly lower than the actual prices. However, when looking at the actual average price as a percent of the forecasted price of crude oil, the number has grown from 119.1% in 2007 to 159.7% in 2009.[226] The result of this underestimation has been either a shift of the property tax burden to other property owners or a reduction in local property tax revenues.

The Oil and Gas industry feels that current law works for mineral appraisals. They also believe that the change in law also is in line with what the voters agreed to in Proposition 3 on the November 2009 ballot: greater statewide uniformity in appraisals. The industry trusts the methodology used by the Comptroller's Office, as the office is the central authority on the Texas economy and serves as an objective source in forecasting changes.[227] It should also be noted that testimony raised concerns about the constitutionality of the previous formula, as future earnings were taxed, though the law was never challenged in court.

Data provided by the Oil and Gas industry shows that even with the declining rates in 2009, oil and gas-dependent counties have had higher taxable wealth, faster growth in taxable wealth, lower tax rates, bigger declines in tax rates and higher tax levies than counties which do not depend on oil and gas revenue. The higher taxable wealth is nine times greater than the per capita level for other rural counties and twelve times the state per capita average for all counties. From 1999-2009, these oil and gas-dependent counties have tripled the growth rate of other counties. Tax rates are 23% lower than other rural counties and 15% lower than the state average. Tax rates fell 8 times faster than the state average at 17 cents per hundred dollars of valuation compared to the state average of 2 cents per hundred. General Fund maintenance and operations tax per capita tax levies 1,253% higher than the state average and 664% higher than other rural counties.[228]

Counties maintain that the new valuation formula has created a loss in revenue and shifted the tax burden from the oil and gas industry to private property owners. The oil and gas industry asserts that current law is working, and the difference in valuation stems from a rise and fall within the industry.

[226] Testimony by Texas Association of Counties and County Judges and Commissioners Association of Texas, House Committee on Ways and Means, March 25, 2010.
[227] Testimony by the Texas Oil & Gas Association, House Committee on Ways and Means, March 25, 2010.
[228] *Id*.

Charge 4

Evaluate the impact of the transfer of administrative law judges from the Comptroller's Office to the State Office of Administrative Hearings on the dispute resolution process.

Under current law, when a central appraisal district (CAD), determines the appraised value of a property, the taxpayer may appeal the determination to an appraisal review board (ARB). If that appeal yields undesirable results, the taxpayer may further appeal the ARB's decision to the district court. A district court offers the assurance of proper consideration and understanding of the arguments being presented without a perception of bias towards one party. Appealing to district court can be a time-consuming and expensive process, thereby reducing the number of taxpayers who choose to pursue such an appeal. An alternative to the current process is needed to reduce litigation expenses, while continuing to provide a neutral third party to hear arguments and issue decisions.[229]

During the 81st Legislature, HB 3612 was passed, creating a three-year pilot program in Bexar, Cameron, Dallas, El Paso, Harris, Tarrant, and Travis counties. This pilot program is an alternative to judicial review of appraisal review board determinations. It allows property owners to appeal appraisal review board determinations for real or personal property valued at more than $1 million (excluding mineral and industrial properties) to the State Office of Administrative Hearings (SOAH). This program began on January 1, 2010 and is limited to appeals of determinations for a three-year period, expiring on January 1, 2013. The decision made by SOAH is final and precludes an appeal in district court.[230]

The Ways & Means Committee met on October 14, 2010 to hear invited and public testimony on Charge 4. Because the deadline for filing protests with the appraisal review board can be extended until May 31 and hearings begin in the months after that, there is currently not much information on the success of this pilot program. Harris County has just over forty cases pending. At the time of the hearing, Jim Robinson, Chief Appraiser, Harris County testified that three of the forty cases had been giving hearings, but no rulings had been made yet. Since the hearing, four more hearings have taken place, bringing the total to seven. At the time that this report was submitted, four determinations had been made: three in favor of the appraisal district and one in favor of the property owner. Nine property owners have settled with the appraisal district with direct negotiation. Two cases were dismissed. According to the appraisal review board, the aggregate market value of the properties is $169,506,377. The average value of an account is $4.4 million; the median value is $2.5 million.[231]

It is too soon to tell how effective this pilot program will be for taxpayers in the appeal process. One recommendation from Harris County is that the Legislature consider providing for district court review of a State Office of Administrative Hearings decision under the substantial evidence review because under current law the SOAH decision is final. This change would fall in line with the current standard procedures for appeals of the SOAH in all other types of cases. The Legislature will be able to further consider this pilot program and its effectiveness once the first year's appeals hearings have been completed and the SOAH has made rulings.

[229] House Bill Analysis for HB 3612, 81R.
[230] Written Testimony by Deborah Cartwright, Director, Property Tax Assistance Division, Texas Comptroller's Office of Public Accounts, House Ways and Means Committee, October 14, 2010.
[231] Written Testimony by Jim Robinson, Chief Appraiser, Harris County Appraisal District to the House Committee on Ways & Means Committee, October 14, 2010.

Charge 5

Study the tax structure as applied to cable versus satellite service to determine if any unfair competition results from state tax policies.

Background and Introduction

During the Second called Special Session of the 79th Legislature in 2005, Senate Bill 5 was passed to address the significant technological changes that had transpired in the communications industry in the ten years since passage of the Public Utility Regulatory Act. The legislation authorized broadband over power line systems, reduced regulations on telecommunications providers, and established a state-issued franchise to provide cable or video services in the state of Texas. This legislation was intended to encourage and accelerate the development of a competitive and advanced services environment and infrastructure.

Since the passage of Senate Bill 5, cable providers have argued that the new changes have given satellite providers an unfair advantage because satellite providers are assessed fewer taxes. During the 81st Legislature, proposed House Bill 3893 would have included direct broadcast satellite service in the list of taxable services and would have imposed an additional tax of seven percent on the sales price of this service, that is provided in an incorporated area, to make the rate of taxation equal to the tax currently imposed on cable television services. It was estimated that House Bill 3893 would have had a positive fiscal impact of $203,783,000 over a two-year time period.[232]

House Bill 3893 was left pending in committee. Subsequently, Speaker Joe Straus directed the Ways & Means Committee to study this issue further. The House Ways & Means committee met on March 25, 2010 in Austin to hear testimony.

At the request of the Chair, the Comptroller's Office provided the Committee with the following data pertaining to cable television, satellite and online video services.

Estimates of state and local sales tax collections on cable television services, as defined by Tax Code Section 151.0033, are shown in the table below (millions of dollars). Please note that the state and local sales tax amounts relate only to video programming and do not include taxes remitted on Internet access or telephone services, or on the sale or rental of hardware.

	State Sales Tax		**Local Sales Taxes**	
Fiscal Year	Cable	Satellite	Cable	Satellite*
2006	$138.4	$100.3	$24.6	$0
2007	149.5	115.3	30.6	0
2008	145.3	133.3	31.0	0
2009	142.1	140.3	30.2	0
2010	140.4	148.8	30.1	0

*Federal law (Telecommunications Act of 1996, SEC.602) prohibits local taxation of direct-to-home satellite services.

Note: Sales taxes collected on online video services cannot be separately estimated from available Comptroller's Office or industry data. When a vendor charges for such services, they are taxable as a cable television service (if downloaded) or as an information service (if streamed). On sales tax returns, however, vendors are not required to report receipts from such sales separately from their sales of other taxable items. Potentially reliable industry sources

[232] Fiscal Note for HB 3893, 81R.

of data for the dollar volume of such sales (e.g., SEC form 10-K filings for publicly traded companies) could not be identified.

Estimates of franchise fee revenues for Texas municipalities from cable companies are as follows:

Calendar Year	Franchise Fee Revenue
2005	$127.8 million
2006	151.5
2007	157.5
2008	153.0
2009	129.5

Texas employment and wages associated with cable and satellite companies for the most recent five calendar years are as follows (these statistics are inclusive of both W-2 and contract employment).

	Cable		Satellite	
Calendar Year	Employment	Wages & Salaries	Employment	Wages & Salaries
2005	47,658	$3,123,096,613	8,721	$352,205,338
2006	46,484	3,217,509,115	9,270	403,772,302
2007	56,348	4,207,182,467	9,432	436,351,794
2008	57,983	4,256,556,863	6,872	315,581,680
2009	54,925	3,956,472,868	6,883	304,177,831

The three tables above are taken from a letter from the Comptroller of Public Accounts to the Chairman dated December 16, 2010.

Cable

In 1996, the Federal Government passed the Telecommunications Act. Section 602 of this Act restricted states from levying local taxes and fees on satellite companies. At this time, the satellite industry was very new, and the government did not want to limit the growth of the industry by overburdening it with excessive taxes or fees. As a result, satellite customers are not charged the local sales tax, while cable customers are, even though to the viewer the services are virtually indistinguishable.

Historically, franchise fees are assessed for the use of a right-of-way. The 1984 Federal Cable Act permits local communities to charge a 5% fee for wire-line cable providers.[233] Cable companies pay a franchise fee for traditional landline telecommunications services because they physically occupy the public rights of way to provide services. This is called the "access line fee". Because satellite companies do not require the use of land to provide their telecommunications services, they do not pay a franchise fee. In Texas, the franchise fees

[233] Written Testimony submitted to the House Ways & Means Committee by Texas Coalition of Cities for Utility Issues concerning the "Studies of Tax Structure as applied to Cable v. Satellite" on April 5, 2010.

collected by municipalities make up roughly 2 1/2% of a city's budget. It is important to note that a city franchise fee is not a tax, it is a fee that a business pays for the right to use taxpayer property.[234]

Ultimately, the additional 7% of taxes and fees (5% franchise fee plus 2% local sales tax) assessed on cable providers is passed down to their customers. Cable companies have long insisted that this gives satellite providers an advantage in the marketplace because their customers automatically pay more in fees, giving satellite the ability to charge less for the same services. They also assert that due to franchise agreements, cable companies are required to maintain and repair the right-of-way that they use for cable lines as well as provide public access channels and other free services to local government. Satellite providers are not subject to any of these requirements, and can therefore offer a lower rate for their services giving customers an incentive to purchase satellite over cable.[235]

While the Telecommunications Act prevents local taxes and fees from being levied on satellite companies, Section 602(c) does give states the right to impose and collect taxes on satellite companies. In order to address the tax disparity between satellite and cable, some states have imposed a statewide tax on satellite services. States are also able to rebate some or all of the taxes collected to local governments if they choose to do so.

Currently, ten states have enacted some sort of satellite tax: Ohio, Kentucky, Delaware, Florida, Massachusetts, North Carolina, Tennessee, Utah, Virginia, and Washington. Legislation in each of these states was written to equalize the tax burden between cable and satellite customers. Their logic was to create a tax-neutral choice when it comes to the competition between cable and satellite providers.

This tax legislation has taken on several forms. North Carolina eliminated local franchise fees and imposed a 6.75% sales tax on both cable and direct broadcast satellite services. The Utah legislation gave cable operators a partial credit toward the 6.25% state sales tax obligation and made them eligible for credit of half of their paid franchise fees, or up to 2.5% off of the state sales tax obligation. Kentucky imposed a state tax of 5.4% on cable and direct broadcast satellite operators and gave cable operators a credit for franchise fees they actually pay to localities.

In response to these legislative changes, lawsuits have been filed by the satellite industry in six of the ten states: Ohio, Kentucky, Florida, North Carolina, Massachusetts, and Tennessee. The satellite industry has challenged that a state controlled and administered video tax parity is unconstitutional on the grounds that this disparity violates the Commerce Clause.[236] So far, no federal or state court has found that a state controlled and administered tax parity regime is unconstitutional. Kentucky's law was struck down because, although the law was state administered, it was locally controlled. Revenue raised was placed in a gross revenues and excise tax fund to be allocated among the state and its political subdivisions, school districts, and

[234] Oral Testimony provided by Bennett Sandlin, Texas Municipal League, House Committee on Ways and Means Committee, March 25, 2010.
[235] *Id*.
[236] Written Testimony submitted to the Ways & Means Committee by Tom Giovanetti, President, Institute for Policy Innovation on March 25,2010.

special districts. The court found that the school district tax was not allowed under Section 602 of the Telecommunications Act, which says that local taxes and fees cannot be levied on satellite companies. The remaining states' laws keep control and administration of the tax at the state level, and as such, the legislation has been upheld by the federal Fourth and Sixth Circuit Courts of Appeal.[237]

To summarize, the cable industry contends that the additional 7% taxes and fees assessed on their industry over satellite create a disparity and that similar services should be taxed and regulated equally. While federal law does prohibit local taxes from being levied against the satellite industry, the Telecommunications Act does allow for statewide taxes to be imposed on satellite companies. Out of the ten states that have passed such laws, nine have been upheld as constitutional by the court system so far. Cable companies maintain that a change in the current law would give Texans a more tax neutral choice when it comes to deciding between cable and satellite services, and would eliminate any preferential treatment from the government.

Satellite

In the state of Texas, there are currently over 2.7 million households who subscribe to either DIRECTV or DISH Network, the two largest satellite providers.[238] AT&T has also entered into a joint marketing agreement with DIRECTV in order to provide competitive video services and satellite services.[239] These satellite providers contend that their customers subscribe to satellite because they are able to offer lower prices, higher quality, and better service. Rural parts of the state often subscribe out of necessity, because the cable industry does not provide service to these areas due to the cost of laying its wires and cables in less populated areas.

Under the current tax structure, satellite providers pay the same as cable providers with regard to state taxes. Satellite providers are subject to the 6.25% state sales tax. However, they are exempted by Section 602 of the Federal Telecommunications Act from paying any local sales tax which can be up to an additional 2%. Because satellite companies do not require access public rights of way to distribute their product, they also do not pay the additional 5% franchise fee charged to cable providers.

Satellite companies support the current tax structure and do not feel it should be changed. They assert that cable providers are charged the "access line fee" because Texas law requires such a tax/fee on all providers who use landline facilities that physically occupy the public rights-of-way to provide services. Satellite companies are not assessed this fee because their product is delivered wirelessly, so they do not occupy the public rights-of-way. Because the "access line fee" has always been considered a user fee, satellite companies believe the purpose of the fee would be undermined if they were forced to pay a corresponding sales tax.

[237] Written Testimony submitted on behalf of the National Cable & Telecommunications Association before the U.S. House Judiciary Subcommittee on Commercial and Administrative Law, February 14, 2008.
[238] Written Testimony submitted to the House Ways & Means Committee by Lori Kalani, Orrick Herrington & Sutcliffe LLP, March 25, 2010.
[239] Written Testimony submitted to the House Ways & Means Committee by Leslie Ward, Sr. Vice President of External Affairs for AT&T, March 25, 2010.

Satellite companies have not completely escaped from paying a form of franchise fees. Satellite companies are required to competitively bid for the use of federally owned spectrum in order to transmit their signals. These companies also have to pay a cost of doing business in preparing, launching, and maintaining their spacecraft in order to get their products to market. It is satellite's position that this can be correlated to the maintenance of the rights-of-way cable providers are required to pay.[240]

Even though satellite and cable providers provide a similar service, satellite sees the difference in delivery method as something that differentiates the industry. The National Taxpayers Union, a proponent for maintaining the current tax structure, asserts that instead of burdening the satellite industry with a tax or fee to equalize the taxes charged to the cable industry, the Legislature should look at ways to lessen the tax burden on the cable industry. As support for reducing taxes, the Heartland Institute, a national nonprofit research and education organization, calculates that the total government tax load on voice, video, and data services is over 15% in Dallas, much higher than the national average of almost 11% for municipalities.[241]

New Technologies

With the development of new technology more and more cable and satellite customers are discontinuing their service and using the Internet to view television programs and movies. As this transition occurs, the state loses sales tax revenue and local communities lose the franchise fee revenue because Internet usage is mostly exempt from sales tax and totally exempt from franchise fee collections due to federal law. This exemption leaves the state and local communities with no options in recovering the revenue lost from customers switching their service. As Internet technology continues to develop and more people choose the Internet as their sole media provider, the state and local communities will have to find some sort of solution to combat the problem of an ever shrinking tax base.

[240] Testimony by National Taxpayers Union, House Ways and Means Committee, March 23, 2010.
[241] *Id*.

Appendix A

TEXAS LEGISLATIVE COUNCIL

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DAVID DEWHURST
Lieutenant Governor
Joint Chair

JOE STRAUS
Speaker of the House
Joint Chair

MEMORANDUM

TO: The Honorable Rene 0. Oliveira
Chair, House Committee on Ways & Means

FROM: Jerry Everhard
Legislative Counsel

DATE: October 22, 2009

SUBJECT: Applicability of Section 24, Article VIII, Texas Constitution, to Franchise Tax Imposed Only on Certain Entities Making a Profit

INTRODUCTION

Section 24, Article VIII, Texas Constitution, in part requires that any portion of a general law enacted by the legislature imposing "a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income," must provide that the portion not take effect "until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax." Other provisions of Section 24 restrict the use of revenue from a tax to which the section applies. You have inquired whether amending the franchise tax under Chapter 171, Tax Code, to impose the tax only on a taxable entity that makes a profit during the period on which the entity's taxable margin is based would result in the franchise tax being subject to Section 24. Although this is a novel question that only a court can decide, this memorandum outlines the analysis a court would undertake in determining the issue and discusses arguments the court would likely consider.

SUMMARY

Whether a franchise tax structured similarly to the existing franchise tax imposed under Chapter 171, Tax Code, except that the tax would be imposed exclusively on a taxable entity that makes a profit, would be subject to Section 24, Article VIII, Texas Constitution, is a question that only a court can decide. Section 24 applies to a tax imposed on the net income of a natural person, so a court must determine whether the proposed tax is imposed on net income, and whether it is imposed on a natural person. Although there are court cases and other legal opinions to which a court may look for guidance on these issues, there is no precedent directly interpreting Section 24 that would provide a definitive answer as to how a court would rule.

Whether the proposed franchise tax is imposed on "net income" requires a determination of the meaning of that term. There are several sources to which a court may look for assistance in defining the term "net income," including case law, statutory law, and technical accounting terms. A court could decide that the current tax imposed on taxable margin is the equivalent of net income because taxable margin represents the taxable entity's gross receipts minus allowable deductions. In the alternative, the court could decide that because not all of a taxable entity's expenses and costs are allowable deductions, the current tax on taxable margin does not represent net income. If the court decides that the current tax is not a tax on net income, the court could decide that the proposed franchise tax is imposed on net income because only a taxable entity that reports a profit would owe the tax. Since taxable entities that do not report profits, and therefore have no net income, do not owe the tax, a court could determine that it follows that the tax is imposed on, although not measured by, a taxable entity's net income.

If a court determined that the proposed franchise tax were imposed on net income, the court would also be required to determine whether the tax is imposed on that income of a natural person, which is a human being as opposed to a legal or other entity. While most taxable entities that are subject to the tax are clearly legal entities, and not natural persons, the court would need to determine whether the tax as applied to certain partnerships actually constitutes a tax imposed on the partners, some of whom could be natural persons. Arguments can be made on both sides of this issue. Again, the court would have various sources from which the court could receive guidance, including case law and statutory provisions, but there is no direct precedent that is determinative as to how the court would rule.

If a court determined that the proposed franchise tax imposes a tax on the net income of a natural person, Section 24 would apply and require voter approval before the tax may take effect. In addition, Section 24 imposes certain restrictions on the use of revenue derived from the tax. If the Texas Legislature wants to be cautious and ensure that any proposed franchise tax is not susceptible to a court challenge on the basis of Section 24, the legislature should either pass a resolution to amend Section 24 and clarify its inapplicability to the tax, or submit the tax to voters in a statewide referendum.

DISCUSSION

I. Section 24, Article VIII, Texas Constitution

Section 24, Article VIII, Texas Constitution, which is colloquially referred to as the "Bullock amendment," provides in pertinent part in Subsection (a):

> (a) A general law enacted by the legislature that imposes a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income, must provide that the portion of the law imposing the tax not

> take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax. . . .

Subsequent provisions of Section 24 prescribe the uses of revenue derived from a tax to which the section applies. Section 24(t) requires that, during the first year the tax is imposed, at least two-thirds of the net revenue be used to reduce ad valorem maintenance and operation taxes levied for the support of primary and secondary public education. During subsequent years, at least two-thirds of the net revenue must be used to continue that relief. Section 24(g) requires that the remainder of the net revenue from the tax be used to support education but does not specify that the education must be primary and secondary education.

It is clear from the text of Section 24(a) that Section 24 applies to a tax that satisfies two requirements. First, the tax must be imposed on "net income." Second, the tax must be levied on the net income of a natural person. Furthermore, "net incomes of natural persons" includes "a person's share of partnership and unincorporated association income" according to the explicit terms of Section 24(a). Although the "net income" and "natural person" criteria must be met for Section 24 to apply to a tax, the section does not define either term.

II. Franchise Tax: Existing and Proposed

Chapter 171, Tax Code, currently imposes a franchise tax on each taxable entity that does business in this state or that is chartered or organized in this state. Section 171.0002, Tax Code, defines "taxable entity" for purposes of the chapter and specifically excludes from that definition general partnerships the direct ownership of which is composed entirely of natural persons and the liability of which is not limited by any state's statute, passive entities, sole proprietorships, and certain entities that are exempt from taxation under specific provisions of Chapter 171.

The computation of a taxable entity's franchise tax liability begins with the entity's total revenue from its entire business. Section 171.002, Tax Code, provides that an entity does not owe any tax if the entity's total revenue is less than or equal to $1 million. If the entity's total revenue is more than $1 million, the entity's tax liability is, in many cases, computed using the entity's taxable margin. Taxable margin is derived under Section 171.101, Tax Code, in part from the lesser of the following three amounts: (i) 70 percent of total revenue; (ii) total revenue minus cost of goods sold; and (iii) total revenue minus compensation. That amount is apportioned and certain allowable deductions are subtracted, yielding the entity's taxable margin. In the alternative, a taxable entity may elect to compute the tax liability using a simplified method authorized by Section 171.1016, Tax Code, which applies a specified rate to the entity's apportioned total revenue. Both methods of computing franchise tax liability allow deductions for certain costs and expenses, but neither method guarantees that a taxable entity will be allowed to deduct all of the entity's costs and expenses from its total revenue before determining its franchise tax liability. Because of this, a taxable entity may still be required to pay franchise tax even though the entity operated at a loss during the period on which the tax report is based.

You have inquired about the applicability of Section 24, Article VIII, Texas Constitution, to a franchise tax that would compute the tax in a manner that would impose tax liability on a taxable entity only if the entity makes a profit during the period on which the entity's tax report is based. This memorandum subsequently refers to this tax as the "proposed" franchise tax. The analysis of the applicability of Section 24 assumes that under the proposed franchise tax the definition of "taxable entity" will be the same as the definition in the existing franchise tax. Further, the proposed tax is assumed to be identical to the existing franchise tax in every other respect except for the additional requirement that a taxable entity must be profitable in order to owe franchise taxes, thereby eliminating the franchise tax liability of taxable entities that are not profitable.

III. Analysis of Application of Section 24 to Proposed Franchise Tax

In determining whether Section 24, Article VIII, Texas Constitution, applies to the proposed franchise tax, a court would determine what constitutes a tax on "net income" and whether taxing any type of taxable entity is the equivalent of taxing a natural person. The court would also interpret the phrase "including a person's share of partnership and unincorporated association income" in Section 24 to determine whether the phrase makes the proposed tax subject to Section 24 because of its application to certain partnerships. A court would consider common law, statutory law, case law, and the plain language of the constitutional provision when adjudicating these issues. If the proposed tax as imposed on any type of taxable entity is considered a tax on the net income of a natural person who is the owner of that entity, then a court will be more likely to find that Section 24 applies to the tax and requires voter approval of the tax before it may take effect. However, if the court were to find that the tax is not imposed on the net income of a natural person who is an owner of the taxable entity because either the court finds that the taxable entity is distinct from the individual owners for franchise tax purposes, or that the tax is not imposed on net income, then the court will likely Conclude that Section 24 does not apply and no referendum is required.

A. Income

1. Net Income and an Income Tax

Section 24, Article VIII, Texas Constitution, applies to certain taxes on net income. However, Section 24 does not define the term "net income." As noted previously, no court has issued an opinion construing the term within the context of Section 24. A court may look to various sources for guidance in construing the term.

A court may look to case law construing "net income" in other contexts for guidance in determining the meaning of the term in Section 24. A Texas court of appeals has stated that, generally, net income means the "excess of *all* revenues and gains for a period over *all* expenses

and losses of the period." *INOVA Diagnostics, Inc. v. Strayhorn,* 166 S.W.3d 394, 401 n.7 (Tex. App.--Austin 2005, pet. denied) (citing Black's Law Dictionary 1040 (6th ed. 1990)). Proponents of the proposed franchise tax may argue that neither the current tax nor the proposed tax is imposed on "net income" as the term is generally used and understood. Rather, because *only* specified allowable deductions, including either cost of goods sold or compensation, may be subtracted from a taxable entity's total revenue for purposes of determining the entity's franchise tax liability, the current tax and proposed tax would not allow the deduction of many elements of costs and expenses that would be deducted to determine net income using this definition. Proponents of the proposed tax would argue, therefore, that both taxes are imposed on modified gross receipts rather than net income.

In the alternative, a court may look to definitions of "net income" provided by sources other than case law in construing the meaning of the term in Section 24. First, a court could impose a technical accounting definition of the ten-n. Proponents of the proposed franchise tax may assert that the current and proposed taxes are not imposed on "net income" as the term is defined in accounting parlance. In accounting terminology, net income is generally the equivalent of the profit recorded by a business entity and is calculated by subtracting from the total revenue received by the entity all of the entity's incurred expenses, which will vary with the type of business in which the entity is engaged. Because not all costs and expenses are allowable deductions from total revenue under the current and proposed taxes, proponents would argue that the taxes are not imposed on net income using this accounting definition.

However, opponents of the tax may argue that Section 24, Article VIII, Texas Constitution, makes no reference to any accounting standards or definitions, and that an accounting definition does not apply. Instead of applying a technical accounting definition, a court may opt to interpret "net income" in a manner consistent with the interpretation of an average voter in 1993 when Section 24 was approved in a statewide referendum. Opponents of the proposed franchise tax would argue that the words used in the provision are to be construed as people generally understand them. See *City of Beaumont v. Bouillion,* 896 S.W.2d 143, 148 (Tex. 1995); *Armbrister v. Morales,* 943 S.W.2d 202, 205 (Tex. App.--Austin 1997, no pet.); Op. Tex. Att'y Gen. No. .11\4-666 (1987), quoting from Opinion 0-5135 at pages 4-5 ("In construing a constitutional provision it should be construed as it was understood by the average voter when he cast his ballot for or against it."); *Spradlin v. Jim Walter Homes, Inc.,* 34 S.W.3d 578, 580 (Tex. 2000). Opponents could argue that average voters certainly did not take into account the technical accounting definition of "net income" at that time. Rather, it is more likely the average voter reading the text of the proposed constitutional amendment interpreted the term "net income" as that provided by Black's Law Dictionary, Fifth Edition, which in 1993 defined "net income" in part as "income subject to taxation after allowable deductions and exemptions have been subtracted from gross or total income." Taxable margin, on which the current and proposed franchise taxes are imposed, may be considered to fall within that definition because taxable margin is calculated by subtracting allowable deductions from total revenue. The fact that there are any allowable deductions results in a net income within the meaning of the term as voters

understood it when Section 24 was approved. In addition, opponents may point to the ballot proposition for Section 24, which refers to "prohibiting a personal income tax without voter approval," and argue that the section was understood by the voters to apply to any tax similar to the federal income tax, which imposes a tax on profit.

2. Person's Share of Partnership and Unincorporated Association Income

Section 24(a), Article VIII, Texas Constitution, applies to a tax on the "net incomes of natural persons, including a person's share of partnership and unincorporated association income ." As noted, this analysis assumes that the proposed franchise tax would be imposed on the same taxable entities to which the current franchise tax applies. The current franchise tax does not include certain general partnerships that do not enjoy liability protections within the definition of "taxable entity" for purposes of imposition of the tax. However, other partnerships with liability protections are included in that definition and are subject to the tax. Because of this, a court would be required to construe the quoted phrase from Section 24 to determine whether the applicability of the current and proposed franchise taxes to certain partnerships brings the tax within the scope of Section 24.

As noted previously, a constitutional provision must be construed by giving its words their natural and ordinary meanings as understood by average voters. See *City of Beaumont,* 896 S.W.2d 143, 148; *Armbrister,* 943 S.W.2d 202; Op. Tex. Att'y Gen. No. JM-666 (1987). There is an argument, in the quoted phrase from Section 24(a), that "a person's share" logically modifies "[income] of [a] natural [person]." The average voter might have read the provision and interpreted it as a ban on any tax imposed without a referendum on *any* income that a person receives from any partnership or unincorporated association. Therefore, any share of that income to be received by a natural person that would become part of the person's "net income" but for the tax may not be taxed without voter approval. The court could decide, however, that because the current and proposed franchise taxes are imposed before the partnership or unincorporated association computes net income and before any of the net income is distributed or attributed to the entity's owners, the taxes are not subject to Section 24. A tax would not be directly imposed on "a person's share of partnership and unincorporated association income," which is determined after the entity's net income is computed, but rather on the entity's revenue before shares are determined.

There may also be a question as to how a court would read the actual text of Section 24. Section 24(a), as noted, refers to "a person's share of partnership and unincorporated association income . . . ." Some may argue for a more restrictive interpretation of the provision. Under this interpretation, only a tax on the "net" income of a partnership or unincorporated association, from which a natural person receives a share, would be subject to Section 24. Opponents will argue that reading the word "net" before "partnership and unincorporated association income" is contrary to the intent of the phrase. Interpolation of words into a constitutional provision should not be resorted to if the interpolation would defeat the overriding intent of the provision. *Mauzy*

v. Legislative Redistricting Board, 471 S.W.2d 570, 573 (Tex. 1971). Opponents would argue that this interpolation materially changes the meaning of Section 24(a) and is inconsistent with the ballot language approved by the voters. Furthermore, the voters approved Section 24 to prohibit the Texas Legislature from taxing personal income, and the phrase in question did not refer solely to a person's share of the "net" income of a partnership or unincorporated association.

3. Profitability Requirement

The foregoing arguments relating to the applicability of Section 24, Article VIII, Texas Constitution, apply equally to the current and proposed franchise taxes because they address the interpretation of Section 24 or the features of the imposition of the tax that are consistent between the current and proposed taxes. The proposed tax, however, has one difference as compared to the current tax. The proposed tax would be imposed only on a taxable entity that reports a profit for the period on which the tax report is based. Assuming that the current franchise tax is not a tax on net income, a court would need to determine whether the addition of the profitability requirement results in the proposed tax being a tax on net income.

Under the current franchise tax, a taxable entity can owe franchise tax even if the entity fails to produce a profit during the reporting period. By altering the tax to require an entity to report a profit before the entity is required to pay the tax, the proposed franchise tax may be more susceptible to claims that the tax is subject to Section 24. One may argue that because the proposed franchise tax will only be levied against a profitable taxable entity, the imposition of the tax relies directly on the profitability of the entity. A taxable entity with no profit, meaning no net income, is not taxed. Because only profitable taxable entities or, in other words, those with a net income, are taxed, the tax is a tax on net income even if the amount of tax owed is not determined by the amount of that net income.

Like the current franchise tax, the proposed franchise tax would have a threshold test that exempts a taxable entity the total revenue of which is less than or equal to $1 million from payment of tax. Proponents may argue that the profitability requirement of the proposed tax is simply an additional threshold test similar to the $1 million threshold test. The proposed franchise tax will exempt from franchise tax liability taxable entities that fail to produce a profit. Profitability does not determine the amount a taxable entity is required to pay, but rather only whether the entity is required to pay the tax. Therefore, one may argue that the profitability requirement does not change the character of the franchise tax and does not make it a tax on net income.

B. Natural Person

Section 24, Article VIII, Texas Constitution, applies to certain taxes imposed on "natural persons." The term "natural person" means a human being, rather than a juristic or artificial person such as a corporation or body politic. *Helvering v. Stockholms Enskilda Bank,* 293 U.S.

84, 92 (1934) (referring to William Blackstone, 1 Commentaries * 116, * 119). Most entities that are considered taxable entities under Chapter 171, Tax Code, including limited liability companies and most other unincorporated associations, are clearly considered purely legal entities that do not fall under the category of a "natural person." Therefore, a tax on. those entities is not subject to Section 24. However, no court has determined whether the franchise tax as imposed on a partnership the direct ownership of which is composed of at least one natural person constitutes a tax on a natural person. A court must adjudicate this issue when determining whether Section 24 applies to the proposed franchise tax.

Proponents of the proposed franchise tax may contend that a shift has occurred over time from the common law view of a partnership as an aggregate of partners to the modem view that a partnership is a separate and distinct entity. Most notably, they may emphasize the 73rd Legislature's simultaneous enactment of the Texas Revised Partnership Act and the joint resolution that resulted in Section 24.

The Texas Revised Partnership Act explicitly states in Section 152.056, Business Organizations Code, that "[a] partnership is an entity distinct from its partners." The legislature could have expressly adopted the older view of a partnership as an aggregate of its partners if it had chosen to do so. Rather, the same legislature that adopted the joint resolution that resulted in Section 24 explicitly declared in the Texas Revised Partnership Act that a partnership is a distinct entity. One may infer that the 73rd Legislature viewed a partnership as being distinct from any of its partners who are natural persons, and intended that Section 24 apply only to a tax on the net income of those partners as individuals, and not to a tax imposed on the income held by the partnership before distribution to the partners. Furthermore, the proposed franchise tax would be imposed on partnerships that enjoy limited liability protections. Proponents may argue that the legislature clearly recognizes these entities as legal entities in their own right, as evidenced by the granting of liability protections. Hence, the proposed franchise tax may not be subject to Section 24 because the tax is imposed on the entity's income rather than on the income of the entity's owners.

In interpreting the Texas Constitution, courts "construe its words as they are generally understood," relying "heavily on the plain language of the Constitution's literal text," and making sure to give effect to all of the words of the provision, if possible. *Spradlin,* 34 S.W.3d 578, 580. Proponents of the proposed franchise tax may assert that the plain language of Section 24 suggests that only natural persons and not business entities are protected from an income tax. They may contend that the provision only refers to "natural persons." The reference to "partnership . . . income" appears in the "including" clause in Section 24(a). Because the term "including" signifies a specific clarification of the term it modifies, they may argue that the phrase "including a person's share of partnership . . . income" is merely an example of "the net incomes of natural persons" and does not create a separate category of income the taxation of which is subject to Section 24. It may be argued that the phrase assumes that the person's share of partnership income has been distributed to the individual because otherwise, the share would

still be considered the property of the partnership. Therefore, it follows that the phrase may not be interpreted to mean that the taxation of a person's potential share of partnership income while still held by the partnership is subject to Section 24. In other words, Section 24 prohibits, without approval in a statewide vote, a tax imposed on a natural person's income received from a partnership, not a tax imposed on the partnership's undistributed income. Thus, proponents of the proposed franchise tax may state that the tax is imposed on a partnership as an entity, rather than a tax on the partners, and therefore Section 24 does not apply even if those partners are natural persons.

However, one may also argue that treating the partnership as a separate entity that is distinct from its owners does not insulate the proposed franchise tax from the application of Section 24. Because Section 24(a) simply refers to "a person's share" of income, whether the tax is imposed directly on a natural person's income, or is imposed indirectly on the income before distribution, but ultimately reducing a person's share, is irrelevant if the true issue addressed by the phrase is whether there is any tax imposed on a person's share of the distribution.

Texas courts have determined that all words in constitutional provisions must be given meaning and effect. Courts avoid constructions that render a constitutional provision meaningless or nugatory. ***Spradlin,*** 34 S.W.3d 578, 580; ***Hanson v. Jordan,*** 198 S.W.2d 262, 263 (Tex. 1946). Opponents may argue that the phrase "a person's share of . . . income" may serve a purpose and be given meaning only if it is interpreted as a conscious act by the legislature to clarify and expressly state that Section 24 applies to the imposition of any tax levied on the receipts that a natural person will receive as a member of a partnership or unincorporated association, regardless of the point in time the tax is imposed.

CONCLUSION

Whether a franchise tax structured similarly to the current franchise tax that would apply exclusively to a taxable entity that makes a profit constitutes a tax on the net income of a natural person and therefore is subject to Section 24, Article VIII, Texas Constitution, is a question that only a court can decide. Although there are court cases and other legal opinions to which a court may look for guidance on the issue, there is no precedent directly interpreting Section 24 that provides a definitive answer as to how a court would rule if confronted with this issue. If the Texas Legislature wants to be cautious and ensure that any proposed franchise tax structured in the stated manner is not susceptible to a court challenge, the legislature should either amend Section 24 to clarify its inapplicability to the tax or submit the tax to voters for approval in a statewide referendum.

09L145

Appendix B

School Offering Local Optional Percentage Homestead Exemptions \

Independent School District Name	Local Optional # homesteads (# granted)	Local Optional % homesteads (% deduction)	Loc. Opt. Hmstd. $ Sec. 11.13 (n) (value $ loss)
Abilene	20,468	5	110,146,506
Alpine	1,918	10	18,098,277
Anahuac	1,894	20	29,258,340
Andrews	3,444	20	53,172,795
Anton	356	10	1,575,476
Arp	1,551	20	37,137,524
Austwell-Tivoli	221	20	1,933,770
Barbers Hill	4,066	20	139,874,120
Beckville	671	20	10,734,750
Big Sandy	453	20	5,476,951
Big Spring	5,383	20	54,722,451
Bishop	1,156	20	18,224,442
Borden County	175	20	717,056
Borger	4,034	10	28,297,940
Brazos	1,059	5	6,253,924
Brazosport	13,459	10	158,800,675
Bridge City	3,475	10	27,286,722
Bridgeport	2,539	1	12,608,974
Broaddus	891	20	5,759,990
Bronte	413	20	4,552,729
Brookeland	791	20	10,433,952
Brownsboro	4,021	20	82,341,784
Buena Vista	95	20	433,740
Buffalo	993	1	4,161,470
Burkeville	607	20	8,662,438
Calhoun County	4,533	20	91,066,612
Canadian	844	20	15,314,550
Carlisle	517	20	7,257,374
Carrizo Springs	1,939	20	13,679,157
Carthage	4,537	20	75,709,490
Cayuga	670	20	9,757,554
Center	2,713	20	34,663,631
Centerville	1,289	20	16,140,550
Central Heights	853	20	12,996,310
Chireno	449	20	5,159,580
Christoval	763	20	18,364,310
Clear Creek	50,016	5	471,619,207
Coahoma	1,060	20	11,402,212
Columbia-Brazoria	4,969	10	50,129,531
Columbus	2,921	1	13,303,302
Comal	26,404	20	1,183,049,223
Comstock	167	5	616,150
Corrigan-Camden	987	20	11,707,488
Crockett County	892	20	7,155,790
Crowley	16,657	10	254,399,209
Cushing	959	20	10,543,470
Cypress-Fairbanks	108,885	20	3,506,985,044
Daingerfield-Lone Star	2,222	20	31,041,257

School Offering Local Optional Percentage Homestead Exemptions \

Independent School District Name	Local Optional # homesteads (# granted)	Local Optional % homesteads (% deduction)	Loc. Opt. Hmstd. $ Sec. 11.13 (n) (value $ loss)
Dallas	162,579	10	3,280,361,953
Deer Park	11,897	20	316,690,445
Dell City	159	20	653,003
Deweyville	843	20	10,413,233
Diboll	1,623	20	21,349,602
Dime Box	365	1	1,571,098
Douglass	583	20	12,145,690
Dumas	3,468	20	65,653,138
East Chambers	1,376	20	23,253,740
Ector County	27,784	20	517,949,771
Elysian Fields	1,331	20	22,454,056
Etoile	491	20	5,873,000
Eustace	2,022	20	46,372,254
Evadale	462	20	5,320,510
Excelsior	152	20	1,474,857
Ezzell	244	20	3,881,938
Forsan	689	20	8,617,018
Fort Stockton	2,737	20	24,696,990
Frankston	1,220	20	23,570,517
Fruitvale	404	20	6,429,932
Galena Park	13,569	20	230,782,255
Galveston	10,148	20	226,423,855
Garrison	810	20	10,423,910
Gary	542	20	7,522,700
George West	2,052	20	23,852,610
Giddings	2,335	10	25,230,397
Gladewater	2,693	20	45,684,791
Glasscock	269	20	3,115,480
Glen Rose	1,946	20	57,022,670
Goliad	2,070	20	25,929,840
Goose Creek	19,284	10	200,408,756
Grady	119	20	1,335,940
Grand Saline	1,569	20	26,768,876
Granfalls-Royalty	124	20	366,110
Greenwood	1,433	20	35,267,752
Groesbeck	2,186	20	37,909,484
Gruver	410	20	5,029,820
Guthrie	38	20	189,630
Hallsville	4,861	20	128,021,730
Hardin-Jefferson	2,990	15	47,404,558
Harleton	766	20	13,965,316
Henderson	5,127	20	97,837,160
High Island	184	20	1,161,804
Highland Park	8,287	20	2,067,756,465
Houston	210,793	20	9,514,963,554
Huntington	2,083	20	28,603,608
Hurst-Euless-Bedford	28,688	1	141,534,011
Industrial	1,032	20	19,255,714

School Offering Local Optional Percentage Homestead Exemptions \

Independent School District Name	Local Optional # homesteads (# granted)	Local Optional % homesteads (% deduction)	Loc. Opt. Hmstd. $ Sec. 11.13 (n) (value $ loss)
Ingleside	1,993	20	41,572,012
Iraan-Sheffield	374	20	3,212,810
Jayton-Girard	234	20	1,018,310
Jefferson	3,079	10	21,242,160
Jim Hogg County	1,223	15	6,685,720
Jim Ned	1,658	20	32,408,881
Joaquin	1,059	20	11,001,093
Karnack	747	20	11,802,324
Kenedy County	42	20	290,817
Kermit	1,494	20	10,447,607
Kilgore	4,687	20	91,957,702
Klondike	97	20	1,226,850
Kountze	1,987	10	13,695,090
La Gloria	54	1	256,196
La Porte	10,407	20	256,713,118
La Poynor	706	20	12,960,470
Lago Vista	3,082	20	147,194,278
Lake Travis	11,255	20	874,634,457
Laneville	509	20	6,362,980
Laredo	10,733	10	81,753,663
Leveretts Chapel	206	20	2,084,260
Lexington	1,569	1	6,861,033
Linden-Kildare	1,846	20	21,475,465
Little Cypress-Mauriceville	5,307	15	83,635,362
Llano	5,248	10	104,231,413
Loop	98	20	1,137,064
Marshall	7,554	20	141,659,127
Martinsville	372	20	5,891,010
Matagorda	325	20	10,288,623
McCamey	624	20	3,113,968
McMullen	243	20	1,952,369
Miami	229	20	2,712,122
Midland	27,256	10	388,930,250
Midlothian	8,239	10	147,071,879
Mineral Wells	1,806	1	7,853,023
Monahans-Wickett-Phillips	2,383	20	14,534,472
Moulton	663	20	9,718,922
Mount Enterprise	524	20	6,286,200
Mount Pleasant	4,733	20	92,734,739
Nacogdoches	8,634	20	172,580,740
Navasota	3,426	20	69,553,691
Neches	407	20	6,343,107
Newton	1,434	20	15,372,871
Nixon-Smiley	977	20	11,795,415
Normangee	1,099	20	17,735,430
Orangefield	2,224	20	44,809,504
Overton	625	20	8,579,170
Paducah	526	20	2,378,450

School Offering Local Optional Percentage Homestead Exemptions \

Independent School District Name	Local Optional # homesteads (# granted)	Local Optional % homesteads (% deduction)	Loc. Opt. Hmstd. $ Sec. 11.13 (n) (value $ loss)
Palacios	1,582	20	27,231,635
Palo Pinto	315	20	12,381,590
Panhandle	965	20	17,902,610
Pasadena	39,345	10	404,888,842
Pawnee	213	20	2,450,267
Pine Tree	5,608	20	154,319,043
Plains	457	20	3,893,746
Plemons-Stinnett-Phillips	748	20	6,588,770
Port Neches	7,523	20	184,584,402
Pringle-Morse	75	20	688,963
Queen City	1,588	20	20,064,251
Ramirez	91	20	143,420
Reagan	746	20	6,714,665
Refugio	1	10	5,826
Ricardo	902	10	8,262,714
Richardson	43,132	10	872,344,606
Riesel	581	10	5,316,902
Riviera	438	20	7,514,225
Robert Lee	514	20	5,041,587
Round Top-Carmine	631	20	16,725,010
Royal	1,757	1	7,778,635
Rule	280	20	1,055,129
Sabine	1,556	20	33,319,100
Sabine Pass	63	20	742,672
San Angelo	20,903	20	410,009,556
San Felipe-Del Rio	8,917	20	145,316,480
Sands	146	20	1,556,592
Sanford	1,436	10	9,374,516
Savoy	538	10	4,285,916
Schleicher	706	20	4,155,444
Sealy	3,252	20	82,461,057
Sheldon	5,389	20	88,868,010
Shepherd	2,008	20	23,952,051
Skidmore-Tynan	711	20	7,575,460
Slidell	413	20	8,741,196
Sonora	995	20	14,530,907
Spring Branch	33,012	20	2,555,459,409
Spring Creek	26	20	183,280
Spring Hill	1,922	15	53,150,404
Spurger	594	10	3,856,674
Stafford	2,678	20	77,093,374
Stanton	919	15	6,816,810
Sundown	409	20	3,953,059
Sweeny	2,686	20	49,492,060
Tatum	1,561	20	26,822,820
Terrell County	294	20	2,295,598
Texas City	5,914	20	104,986,850
Three Rivers	962	20	10,452,610

School Offering Local Optional Percentage Homestead Exemptions \

Independent District Name	School	Local Optional # homesteads (# granted)	Local Optional % homesteads (% deduction)	Loc. Opt. Hmstd. $ Sec. 11.13 (n) (value $ loss)
Tidehaven		975	20	14,610,262
Timpson		1,042	20	10,022,233
Trinidad		208	20	2,014,444
Troy		9	1	46,690
Tuloso-Midway		2,318	20	52,879,743
United		24,338	15	485,572,524
Van		3,379	20	68,406,063
Van Vleck		1,517	20	30,056,580
Veribest		308	20	5,088,750
Vidor		6,422	15	73,837,377
Vysehrad		256	20	4,685,136
Waskom		1,002	20	16,079,726
Water Valley		462	20	5,694,232
Webb Consolidated		249	20	1,753,266
West Orange-Cove		3,885	20	57,718,854
West Rusk		1,332	20	18,306,120
West Sabine		751	20	5,441,730
White Deer		516	20	5,397,285
White Oak		1,543	20	40,782,689
Winfield		185	20	2,470,272
Wink-Loving		238	20	1,501,532
Woden		843	20	11,671,840
Ysleta		39,058	20	808,364,056
Zapata		3,319	20	32,852,096
Zavalla		843	20	8,733,650
		1,300,713		34,392,321,448

Appendix C

Local Optional $3000 Exemption

Independent District Name	School	$3,000 65+ $ local optional hmstd. (# granted)	$3,000 Disabled # local optional hmstd. (# granted)	$3,000 65+ or Disabled Local Optional Hmstd. $ Local Optional (value $ loss)
Academy		326	0	1,722,710
Albany		259	32	631,687
Aldine		7,118	1,496	77,556,722
Alief		4,681	0	59,258,443
Alvin		3,558	0	32,012,625
Anahuac		585	130	13,072,190
Andrews		948	0	5,860,509
Angleton		1,877	0	39,907,343
Austin		23,804	2,385	617,376,237
Austwell-Tivoli		98	3	540,340
Bandera		1,810	0	9,813,871
Barbers Hill		659	139	71,490,990
Beaumont		8,264	1,525	36,843,010
Big Sandy		322	0	822,628
Bishop		360	0	3,634,040
Bloomington		235	0	673,116
Boyd		393	0	1,161,920
Brazosport		3,419	0	32,307,119
Brenham		2,740	0	12,998,738
Bridge City		1,060	0	8,803,540
Brooks		637	0	1,651,799
Brownsboro		1,453	0	8,393,040
Brownsville		7,476	1,292	34,452,829
Burleson		2,946	477	83,421,838
Caddo Mills		395	0	1,758,179
Calallen		1,157	275	68,235,742
Calhoun County		1,861	0	16,399,765
Carlisle		64	11	990,862
Carrizo Springs		703	0	3,749,573
Carroll		766	62	26,285,411
Cayuga		151	0	437,832
Central Heights		236	70	3,841,618
Channelview		936	0	24,691,268
Chireno		157	32	2,606,380
City View		386	0	1,943,431
Clear Creek		9,442	934	186,484,882
Cleburne		2,464	0	17,042,242
Cleveland		1,244	0	3,164,390
College Station		2,503	0	12,269,154
Columbia-Brazoria		1,546	0	7,019,004
Conroe		11,077	0	54,674,957
Copperas Cove		1,501	0	7,738,783
Corpus Christi		13,867	3,650	683,453,635
Crane		282	0	5,414,380
Crosby		1,474	290	18,908,497
Crystal City		241	0	1,560,118
Cushing		342	61	4,948,190

Local Optional $3000 Exemption

Independent School District Name	$3,000 65+ $ local optional hmstd. (# granted)	$3,000 Disabled # local optional hmstd. (# granted)	$3,000 65+ or Disabled Local Optional Hmstd. $ Local Optional (value $ loss)
Cypress-Fairbanks	14,026	2,024	230,109,435
Daingerfield-Lone Star	20	8	153,205
Dallas	47,136	7,245	1,521,013,996
Danbury	202	0	1,906,026
Dayton	1,295	0	15,095,886
De Soto	2,247	520	38,003,957
Deer Park	2,534	435	93,202,820
Denison	2,725	0	12,064,816
Denver City	320	0	2,621,601
Devers	80	0	396,637
Diboll	499	0	4,076,783
Dilley	264	0	1,365,497
Doss	9	0	90,000
Douglass	155	33	3,221,210
Duncanville	3,071	2	15,349,251
Eagle Mountain-Saginaw	2,509	373	41,541,180
Eanes	1,632	79	34,007,283
Edgewood	4,503	0	41,169,227
Edinburg	3,543	0	18,567,062
Edna	684	0	2,205,070
Electra	368	0	1,248,843
Elysian Fields	335	0	850,247
Ennis	1,664	0	18,114,403
Etoile	169	59	4,802,530
Fairfield	988	0	5,104,680
Ferris	467	0	1,632,273
Flour Bluff	1,723	411	81,620,228
Freer	265	0	5,512,648
Friendswood	1,508	105	16,085,833
Galena Park	2,910	3	19,811,743
Garrison	321	51	5,209,440
George West	684	93	777
Georgetown	6,122	0	18,337,777
Giddings	846	0	2,216,833
Gilmer	1,500	0	9,904,138
Gladewater	629	25	2,841,737
Glen Rose	626	67	6,145,118
Godley	12	1	0
Goose Creek	4,924	755	74,606,523
Gordon	0	6	47,510
Grand Prairie	4,625	2	20,467,758
Grape Creek	502	121	4,271,800
Grapevine-Colleyville	2,764	205	79,422,682
Gregory-Portland	1,049	0	5,197,727
Hardin	669	0	4,844,618
Harlandale	4,783	873	23,174,086
Higgins	39	0	114,800

Local Optional $3000 Exemption

Independent School District Name	$3,000 65+ $ local optional hmstd. (# granted)	$3,000 Disabled # local optional hmstd. (# granted)	$3,000 65+ or Disabled Local Optional Hmstd. $ Local Optional (value $ loss)
High Island	108	0	258,730
Houston	62,209	6,613	325,160,622
Hudson	668	0	12,154,546
Huffman	854	14	12,066,620
Humble	6,422	0	31,342,678
Huntington	673	0	3,124,008
Huntsville	3,044	0	15,531,238
Hurst-Euless-Bedford	7,643	529	39,868,261
Iowa Park	959	0	4,327,093
Italy	200	0	549,725
Jacksonville	2,085	0	8,702,321
Jasper	1,533	295	4,802,798
Jim Hogg County	433	69	576,570
Jourdanton	365	0	2,947,232
Katy	7,056	0	68,465,490
Keller	3,939	557	37,782,215
Kenedy County	11	0	9,000
Kennedale	824	118	21,704,888
Kilgore	1,698	0	5,807,950
Klein	8,266	1,120	105,920,080
La Joya	2,325	0	10,847,289
La Porte	1,890	385	60,810,664
La Poynor	235	35	2,501,541
Lake Worth	573	93	26,381,473
Leggett	79	0	1,200,819
Lexington	531	0	2,653,403
Liberty Hill	608	0	1,812,321
Lipan	0	1	8,470
Livingston	2,085	416	3,684,595
Lockhart	1,405	0	5,202,644
Longview	4,053	611	23,715,861
Loop	39	1	461,440
Lovejoy	1,162	0	4,612,000
Lubbock	11,982	0	55,384,465
Malakoff	1,332	0	9,773,810
Manor	650	174	16,869,980
Marble Falls	2,317	0	6,533,150
Martinsville	112	13	2,139,280
Mason	533	0	4,706,900
Mathis	107	12	119
Maypearl	235	0	646,502
McCamey	183	62	509,914
Medina	248	0	2,191,396
Mesquite	6,793	984	96,594,082
Mildred	230	36	1,290,710
Mineral Wells	10	0	49,265
Mount Vernon	939	100	5,597,710

Local Optional $3000 Exemption

Independent District Name	School	$3,000 65+ $ local optional hmstd. (# granted)	$3,000 Disabled # local optional hmstd. (# granted)	$3,000 65+ or Disabled Local Optional Hmstd. $ Local Optional (value $ loss)
Nacogdoches		2,710	414	25,739,890
New Braunfels		3,517	308	13,818,928
North East		23,813	2,009	307,229,446
Northside		21,345	3,110	308,436,675
Odem		287	0	833,788
Pasadena		8,992	1,422	49,939,324
Pearland		4,030	0	14,902,950
Perrin-Whitt		129	24	591,940
Pflugerville		2,277	0	19,472,560
Pilot Point		516	0	2,892,205
Pine Tree		1,839	0	17,464,882
Plains		145	0	788,987
Port Aransas		440	49	4,824,379
Port Arthur		4,116	1,220	48,677,040
Prairiland		559	0	2,119,594
Premont		238	0	1,501,127
Pringle-Morse		26	0	54,000
Quitman		1,070	0	4,835,682
Ranger		270	58	390,930
Redwater		344	70	918,173
Rivercrest		451	0	933,139
Rockdale		814	0	4,002,935
Rockwall		3,168	0	62,234,382
Round Rock		0	618	1,830,540
Roxton		139	0	442,313
Royse City		713	0	2,628,599
Rusk		988	0	4,794,803
Sabine		475	76	2,769,361
Sabine Pass		20	2	75,570
Salado		749	0	2,398,787
San Angelo		0	702	13,479,080
Sanger		705	0	3,989,113
Santa Fe		1,584	0	7,815,929
Seminole		592	0	1,420,681
Sheldon		769	226	653,098
Sherman		2,856	0	12,894,143
South San Antonio		2,567	0	36,294,371
Spearman		7	0	140,970
Spring		4,069	765	79,322,643
Spring Branch		10,765	376	228,238,540
Spring Hill		357	48	1,542,570
Sulphur Springs		1,793	0	10,552,640
Sundown		95	10	458,569
Sweeny		813	0	4,886,625
Sweetwater		1,140	97	3,792,174
Tarkington		639	0	1,664,926
Temple		4,142	300	20,173,451

Local Optional $3000 Exemption

Independent District Name	School	$3,000 65+ $ local optional hmstd. (# granted)	$3,000 Disabled # local optional hmstd. (# granted)	$3,000 65+ or Disabled Local Optional Hmstd. $ Local Optional (value $ loss)
Terrell County		127	0	994,881
Texas City		1,850	0	19,428,834
Three Rivers		304	49	353
Tomball		2,344	5	48,597,696
Troup		469	30	1,886,564
Troy		430	0	2,515,196
Vega		119	3	351,990
Waxahachie		2,210	343	11,871,571
White Deer		8	0	49,301
White Oak		420	64	6,405,180
White Settlement		1,431	194	26,943,565
Whitesboro		1,040	0	4,182,279
Whitney		1,205	204	5,636,265
Woden		216	76	4,436,340
		534,661	51,470	7,311,217,606

Appendix D

'TEXAS LEGISLATIVE COUNCIL

P.O. Box 12128, Capitol Station
Austin, Texas 78711-2128
Telephone: 512/463-1151

DAVID DEWHURST
Lieutenant Governor
Joint Chair

JOE STRAUS
Speaker of the House
Joint Chair

MEMORANDUM

TO: The Honorable Rene Oliveira
Chair, House Committee on Ways and Means

FROM: Chris Kuykendall
Senior Research Associate

DATE: March 3, 2010

SUBJECT: History of Texas Severance Taxes

Texas' initial severance tax was a tax on oil. Enacted in 1905, it was the first state oil severance tax,[1] even though Pennsylvania, West Virginia, Ohio, California, New York, Colorado, Indiana, and Kansas were substantial oil producers before Texas,[2] but it was not the first severance tax generally. Michigan placed a severance tax on mineral ores and mine products, including iron, in 1846.[3] Oklahoma levied a tax on natural gas in 1908.[4] Texas' first long intrastate gas pipeline was completed in 1910 and its first interstate gas pipelines were completed in the late 1920s,[5] and Texas enacted a severance tax on gas in 1931.[6]

Reporting in 1989, the Select Committee on Tax Equity advanced some of the rationales behind the concept of severance taxation but noted that the 1905 enactment was probably not so much "theoretically purposeful" as a means to reduce a budgetary deficit,[7] an assessment supported by the fact that the theoretical rationales in the literature all seem to appear after 1905.[8] At the outset of the 1905 session, fiscal matters were said to be the "absorbing problem."[9] The comptroller of public accounts' revenue estimates had projected deficits for the end of both fiscal years 1905 and 1906.[1°] The oil tax was only one portion of an omnibus "Kennedy bill" that also taxed telegraph lines, telephone companies, water works plants, surety and guaranty companies, textbook and law book publishers, rail-affiliated businesses such 'as sleeping car companies, and other enterprises. It was designed as an occupation tax on oil producers, although the amount of the tax was determined by the value of the oil severed from the natural setting. Such a design helped to ensure its constitutional validity and additionally directed one-fourth of the tax revenue to public education under constitutional provisions governing occupation taxes. The courts upheld the tax partly on the distinction between how the tax was placed and how the tax amount was determined.((

The original tax rate was 1.0 percent of value. That was decreased to 0.5 percent of value in 1907 and was increased to 1.5 percent of value in 1919 and to 2.0 percent of value in 1923. The tax rate for gas, when the gas severance tax was enacted in 1931, was also 2.0 percent.[12] The 1931 legislation, which included a cigarette tax, had the combined purpose of eliminating a deficit and preserving per-student school funding.[13] A 1933 change set a floor on the oil tax at $0.02 per barrel when the value was $1 per barrel or less. A 1936 change increased the oil tax to $0.0275 per barrel for oil valued at $1 per barrel or less, or 2.75 percent of value otherwise, and increased the gas tax to 3.0 percent. In 1941, the rates were increased to $0.04125 per barrel or 4.125 percent of value for oil and to 5.2 percent of value for gas, and in 1951, after temporary increases in 1950, to $.046 per barrel or 4.6 percent of value for oil and to 5.72 percent of value for gas. The oil tax rate is now the greater of the per-barrel or percentage amount. A 1954 enactment increased the gas tax rate to 9.0 percent of value through the end of fiscal year 1955, with a reduction to 8.0 percent in fiscal year 1956 and a reduction to 7.0 percent thereafter. A 1969 change set the current gas tax rate of 7.5 percent." Beginning in 1941, legislation expressly addressed liquid condensate from gas, which has been taxed at an oil rate rather than a gas rate.[15] Since 1989, the legislature has adopted a number of oil and gas severance tax breaks to encourage enhanced oil recovery, new field discoveries, the return of inactive wells to production, the production of high-cost gas, or other means to boost output.[16]

Rationales offered for severance taxes include the contention that severed resources, while often privately owned, are a common natural heritage, and in the case of oil and gas are a finite resource extracted on a one-time basis, thus justifying compensation to the public for the depletion of that endowment." It is sometimes argued that such taxation can moderate the pace at which finite resources are exhausted or renewable resources used, encouraging conservation.[18] The severance tax may be seen as a privilege tax for doing business or as a means to reflect the benefits conferred or the costs incurred by the state in conjunction with such business.[19] Other rationales relate to the comparative ease of tax administration or of the quantification and valuation of extracted resources," taxation of out-of-state consumers who obtain value from the resource,[21] and—especially in the case of coal, which is not subject to any Texas severance tax--an internalization or reflection of the fuel's environmental costs.[22] Another is that a severance tax can serve as a convenient means to collect statistics on a resource and its extraction.[23]

Texas has no severance tax on coal corresponding to the taxes on oil and gas. The lack of such a tax, or one on natural resources generally, has been mentioned occasionally over the years.[24] Four bills to tax coal have received legislative committee hearings in the last 20 years, but only one of those, Senate Bill 733 by Senator Teel Bivins in 1993, proposed a severance tax. The others, all by Representative Lon Burnam from the 1999-2003 period, proposed a use tax on coal, including not only Texas lignite but coal imported from other states, chiefly Wyoming.[25] Senator Bivins, whose bill included a gas tax reduction, argued that a severance tax on coal would achieve tax equality among the three fossil fuels.[26] Advocates of the Burnam legislation, while voicing environmental concerns, used similar parity arguments,[27] as did one energy

industry witness testifying on the Bivins bill.[28] Mining industry officials emphasized that Texas lignite was just barely competing with other fuels for electric generation and that a severance tax limited to such lignite, or even a use tax also covering imported coal, would mean ruin for the largely rural Texas lignite industry.[29] Coal tax opponents also raised issues of increased electric rates[3] and, in the case of use taxes, potential interference with interstate commerce.[31]

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Notes

Tax Research Bureau of Texas, *Natural Resource Taxation in Texas* (Dallas: Tax Research Bureau of Texas, 1940), pp. 9-10; Texas Legislative Council, *A Survey of Taxation in Texas*, Part II--Analysis of Individual Taxes (Austin: Texas Legislative Council, 1951), p. 142; Ara Merjanian, "Texas Oil and Gas Severance Taxes," in Billy C. Hamilton, ed., *Rethinking Texas Taxes: Final Report of the Select Committee on Tax Equity,* Volume 2--Analysis of the Tax System (Austin: Texas House of Representatives, 1989), pp. 260-261; Section 13, Chapter 148, Acts of the 29th Legislature, Regular Session, 1905.

[2] American Petroleum Institute, *Petroleum Facts and Figures,* Centennial Edition (New York: American Petroleum Institute, 1959), pp. 40-41.

[3] Thomas F. Stinson, *State Taxation of Mineral Deposits and Production,* Rural Development Research Report No. 2 (Washington, D.C.: U.S. Department of Agriculture, 1978), p. 6; "Wars Between the States," *Time* 118:8 (August 24, 1981); Merjanian, p. 260; Section 14, Michigan Public Acts No. 148, 1846 Annual Session.

[4] Charles Gustavus Haglund, "Taxation of Oil and Gas Interests," *Kentucky Law Journal* 20 (March 1932), pp. 260-261.

[5] Texas Legislative Council, 1951, p. 179.

[6] Merjanian, p. 261; Sections 2 and 3, Chapter 73, General Laws, Acts of the 42nd Legislature, Regular Session, 1931.

[7] Merjanian, pp. 260-261.

[8] George Vaughan, "Severance Tax and Kindred Exactions," *Southwestern Political Science Quarterly* 2 (March 1922), pp. 292-297; Governor Dan Moody, address to the Texas Senate and Texas House of Representatives, House Journal, January 15, 1931, pp. 21-22; Haglund, p. 260; Leslie Moses, "The Growth of Severance Taxation in Louisiana and Its Relation to the Oil and Gas Industry," *Tulane Law Review* 17 (April 1943), pp. 602-603, 618; Texas State Tax Study Commission, *Report of the Texas State Tax Study Commission, Ch. 441, Acts 55th Legislature, Reg. Session* (Austin: Texas State Tax Study Commission, 1959), p. C-166; Laurie Dennis Belzung, "Economic Implications of State Fiscal Dependence on Oil and Natural Gas Taxation in Texas" (Ph.D. diss., University of Texas, 1961), pp. 20-63; David Stephenson, *Occupational (Severance) Taxes on Natural Gas in Texas: A History* (Austin: Secretary of the Senate, 1969), p. 1; Ronald A. Kaiser and James E. Fletcher, "State Policies and Practices in Coal Severance Taxation," *Natural Resources Journal* 27 (1987), pp. 595-598; Merjanian, pp. 260-261. Stinson, pp. 2-3, 6-14, evaluates the various types of severance tax,

which set a specific tax on each unit of production or set a percentage tax on the gross value or net value of production.

[9] "The Legislature and What It Has to Consider When It Meets Tuesday," *Austin American,* January 8, 1905.

o "Governor's Message Read at the Joint Session of the Twenty-Ninth Legislature of the State of Texas," *Austin American,* January 15, 1905; "Fight on Tax Bills," *Galveston Daily News,* February 15, 1905.

11 "Tax Fight Is Over," *Galveston Daily News,* February 16, 1905; "Kennedy Put Wise," *Galveston Daily News,* March 2, 1905; "Reach Agreement," *Galveston Daily News,* April 13, 1905; Chapter 148, Acts of the 29th Legislature, Regular Session, 1905; *Producers' Oil Company v. Stephens,* 99 S.W. 157 (Tex. Civ. App. 1906, writ refd); Merjanian, p. 263; Section 1(c), Article VIII, and Section 3(a), Article VII, Texas Constitution. The one-fourth dedication of the occupation tax, from Section 3(a), Article VII, was added in 1883. Joint Resolution 5, Acts of the 18th Legislature, Regular Session, 1883; Robert H. Angell, *A Compilation and Analysis of the 1998 Texas Constitution and the Original 1876 Text* (Lewiston, Maine: Edwin Mellen Press, 1998), pp. 16-17, 131-132, 151; Texas Legislative Council, *Amendments to the Texas Constitution Since 1876* (Austin: Texas Legislative Council, 2008), pp. 59-60, 67-69.

[12] Merjanian, p. 262; Section 13, Chapter 148, Acts of the 29th Legislature, Regular Session, 1905; Section 15, Chapter 18, Acts of the 30th Legislature, 1st Called Session, 1907; Section 1, Chapter 77, Acts of the 36th Legislature, Regular Session, 1919; Section 1, Chapter 45, Acts of the 38th Legislature, 2nd Called Session, 1923; Section 3, Chapter 73, General Laws, Acts of the 42nd Legislature, Regular Session, 1931.

[13] Ed Kilman, "Cigarette Tax Bill Is Pushed," *Houston Post-Dispatch,* April 17, 1931; Ed Kilman, "Passage of Cigarette Tax Is Seen," *Houston Post-Dispatch,* April 18, 1931; Section 11, Chapter 73, Acts of the 42nd Legislature, Regular Session, 1931.

14 Merjanian, p. 262; Section 2, Chapter 162, General Laws, Acts of the 43rd Legislature, Regular Session, 1933; Sections 4 and 8, Article IV, Chapter 495, Acts of the 44th Legislature, 3rd Called Session, 1936; Articles I and II, Chapter 184, Acts of the 47th Legislature, Regular Session, 1941; Section 1, Article I, and Section 1, Article II, Chapter 2, Acts of the 51st Legislature, 1st Called Session, 1950; Sections 1 and 3, Chapter 402, Acts of the 52nd Legislature, Regular Session, 1951; Section 1, Article I, Chapter 2, Acts of the 53rd Legislature, 1st Called Session, 1954; Section 1, Article V, Chapter 1, Acts of the 61st Legislature, 2nd Called Session, 1969. Now, on the basic gas and oil severance tax rates, see Sections 201.052 and 202.052, Tax Code. The change to the greater of 4.6 cents per barrel or 4.6 percent of value appears to have come from the 1981 recodification adopting the Tax Code. See Chapter 389,

Acts of the 67th Legislature, Regular Session, 1981, at p. 1737, adopting Section 202.052, Tax Code. Arithmetically, this change in the course of recodification is nonsubstantive.

[15] Section 1, Article II, Chapter 184, Acts of the 47th Legislature, Regular Session, 1941 (the last sentence of the second full paragraph on p. 277 of the session laws); *Calvert v. Union Producing Company*, 258 S.W.2d 176 (Tex. Civ. App.--Austin 1953, no writ). A 1945 law, as explained in *Calvert v. Union Producing Company*, provided that liquid hydrocarbons (condensate) were to be taxed at the same rate as the oil rate set in 1941. Section 1, Chapter 269, Acts of the 49th Legislature, Regular Session, 1945 (the third full paragraph on p. 424 of the session laws). When the 1950 law increased the oil tax rate temporarily, the tax rate on condensate, having been tied to the 1941 oil tax rate, did not follow suit, creating a discrepancy. Chapter 142, Acts of the 53rd Legislature, Regular Session, 1953, restored the coupling between the oil tax rate and the condensate tax rate.

[16] Chapter 795, Acts of the 71st Legislature, Regular Session, 1989; Chapter 33, Acts of the 71st Legislature, 1st Called Session, 1989; Chapters 335, 1014, and 1015, Acts of the 73rd Legislature, Regular Session, 1993; Chapter 895, Acts of the 74th Legislature, Regular Session, 1995; Chapters 208 and 1060, Acts of the 75th Legislature, Regular Session, 1997; Chapters 1, 365, and 893, Acts of the 76th Legislature, Regular Session, 1999; Sections 7-12, Chapter 267, Acts of the 79th Legislature, Regular Session, 2005; Section 4, Chapter 911, Section 19, Chapter 931, and Section 9, Chapter 1277, Acts of the 80th Legislature, Regular Session, 2007; Chapter 1036 and Section 5, Chapter 1109, Acts of the 81st Legislature, Regular Session, 2009. This is not necessarily an exhaustive list.

[17] Moses, p. 602; Texas Legislative Council, 1951, pp. 146-147; Belzung, pp. 21-23; Kaiser and Fletcher, pp. 595-596; Merjanian, p. 260.

[18] Vaughan, pp. 292, 295; Moses, pp. 602, 618; Texas State Tax Study Commission, p. C-166; Belzung, p. 21; Kaiser and Fletcher, pp. 596-597.

[19] Vaughan, p. 293; Stephenson, p. 1; Merjanian, p. 260.

[20] Haglund, p. 260. Vaughan, p. 297, and Moses, p. 603, combine to suggest (paraphrasing) that the valuation of a resource for tax purposes can be difficult to accomplish while the resource is still physically hidden or until the severance of the resource and the associated placement of a market price on the resource occur.

[21] Belzung, pp. 36-39; Kaiser and Fletcher, p. 597; Merjanian, pp. 260-261.

[22] Kaiser and Fletcher, pp. 596-597; Public Citizen and Texas Center for Policy Studies, *Making Polluters Pay: Environmentally Responsible Ways the 78th Legislature Can Raise New State Funds* (Austin: Public Citizen, 2003), pp. 10-11.

[23] Vaughan, p. 295.

[24] William M. Thornton, "Severance Tax on Resources to be Sought," *Dallas Morning News*, October 26, 1938; Tax Research Bureau of Texas, p. 9; "Taxless Resources in Texas Pointed Out for Legislature," *Dallas Morning News*, December 14, 1952; Belzung, p. 46; Mike Kingston, "Tax Texas' Natural Resources," *Dallas Morning News*, July 9, 1981.

[25] House Bill 3608, 76th Legislature, Regular Session, 1999; House Bill 2901, 77th Legislature, Regular Session, 2001; House Bill 1486, 78th Legislature, Regular Session, 2003.

[26] Section 2, Senate Bill 733, 73rd Legislature, Regular Session, 1993; "Lawmaker Files Bills Promoting Energy Industry," *Amarillo Daily News*, March 10, 1993; Senator Teel Bivins, presentation laying out Senate Bill 733, and later answering a question on the fiscal note, before the Senate Committee on Finance, 73rd Legislature, Regular Session, April 28, 1993.

[27] Tom (Smitty) Smith, Public Citizen, and Peter Altman, SEED (Sustainable Energy and Economic Development) Coalition, testimony on House Bill 2901 before the House Committee on Ways and Means, 77th Legislature, Regular Session, April 25, 2001; Cyrus Reed, Texas Center for Policy Studies, testimony on House Bill 1486, before the House Committee on Ways and Means, 78th Legislature, Regular Session, May 10, 2003.

[28] Bruce Stram, Enron, testimony on Senate Bill 733, before the Senate Committee on Finance, 73rd Legislature, Regular Session, April 28, 1993. Also from the energy industry in support of Senator Bivins' bill were Scott Anderson, Texas Independent Producers and Royalty Owners Association, who registered in favor but did not testify, and Steve Perry, Texaco, who submitted written testimony in favor but did not testify.

[29] J. J. Hill, Texas Mining and Reclamation Association (and also Alcoa), and Paul Thompson, Phillips Coal Company (a wholly owned subsidiary of Phillips Petroleum), testimony on Senate Bill 733 before the Senate Committee on Finance, 73rd Legislature, Regular Session, 1993; Carroll Embry, Texas Mining and Reclamation Association, and Paul Thompson, Phillips Coal Company, testimony on House Bill 3608 before the House Committee on Ways and Means, 76th Legislature, Regular Session, April 21, 1999; Lynn Bell, Texas Mining and Reclamation Association, testimony on House Bill 1486 before the House Committee on Ways and Means, 78th Legislature, Regular Session, May 10, 2003.

[30] Shawn Glacken, Association of Electric Companies of Texas, Randy Eminger, Center for Energy and Economic Development, and Carroll Embry, Texas Mining and Reclamation Association, testimony on House Bill 3608 before the House Committee on Ways and Means, 76th Legislature, Regular Session, April 21, 1999; Daniel Kuehn, Lower Colorado River Authority, testimony on House Bill 2901 before the House Committee on Ways and Means, 77th Legislature, Regular Session, April 25, 2001.

[31] Eminger and Kuehn, supra note 30. Kuehn referenced measures in Oklahoma, Indiana, Illinois, and Ohio that had been overturned by federal courts on interstate commerce grounds but did not offer specifics about those bills' contents, the court cases involved, or the reason for the court decisions. The interstate commerce clause of the U.S. Constitution was not referenced specifically in the court's 1906 decision in ***Producers' Oil Company v. Stephens,*** but the court ruled that the state's 1905 occupation tax on oil producers did not violate any provision of that constitution. In contrast, later Texas legislation adopting a gas gathering tax, a severance beneficiary tax, and a dedicated reserve tax, trying by successive means to tax interstate pipelines at their origin in Texas, was in each case rejected by the courts. Harry M. Reasoner, "Texas Attempts Alchemy: The Commerce Clause and Efforts to Tax Interstate Gas Pipeline Companies," ***Texas Law Review*** 43:2 (December 1964), pp. 222-235. More recently, the U.S. Supreme Court upheld, against the interstate-commerce clause and other arguments, a coal severance tax in Montana containing a controversial maximum rate of 30 percent. "War Between the States," supra note 3; John S. Lowe, "Severance Taxes as an Issue of Energy Sectionalism," ***Energy Law Journal*** 5:2 (1984), pp. 361-367. This memorandum does not speculate on the interstate-commerce legal implications of a prospective coal use tax. The research supporting the memorandum has not identified the cases to which Kuehn referred.

Appendix E

STATE OF TEXAS
HOUSE OF REPRESENTATIVES

January 5, 2011

The Honorable Rene Oliveira
State Representative
Capitol Building, 3N.06
Austin, TX 78701

Dear Chairman Oliveira,

Thank you for the time and effort you and your staff have put into the Ways & Means Committee interim report. The topics presented to the committee over the past year were necessary to study, especially in light of our state and national economy.

I would like to offer a word of caution regarding the expansion of the tax base through the justification of specific exemptions and exploring the taxation of new services. The Texas economy has seen its largest growth over the past couple of decades in professional services and retail sales. Oil and natural gas, manufacturing, and heavy industry are still vitally important to our state's economy as these trades produce much needed jobs and substantial tax revenue. While Texas remains the nation's economic powerhouse in many respects, our tax laws reflect an older economy that is property rich.

As the committee has studied the possible taxation of services, the justification of exemptions, and the structure of state tax policies, it has become clear to me that the Texas economy could expand through the eventual elimination of the property tax. The property tax is difficult to administer, discourages capital-intensive industries, and creates frustration among homeowners through rising appraisals. President Ronald Reagan's Chief Economist Art Laffer said in his publication *Enhancing Texas' Economic Growth Through Tax Reform*, "While all taxes create a negative impact, property taxes create a larger tax wedge than consumption taxes."242

A decision to remove a tax exemption, the increase in the tax rate, or the expansion of the sales tax base should not be taken lightly as the tax increase will be felt within the economy as a whole. Any expansion of one tax should result in the contraction or elimination of the property tax to create a tax

242 Dr. Art Laffer, *"Enhancing Texas' Economic Growth Through Tax Reform,"* p 3. Prepared by Arduin, Laffer, Moore Econometrics in conjunction with Texas Public Policy Foundation, April 2009. http://www.texaspolicy.com/pdf/2009-04-taxswap-laffer-posting.pdf

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system that reflects our economy and will help the overall Texas economy grow. An increase in state tax revenues through a tax increase at this time would be detrimental to businesses and individuals, so any tax restructure should result in a net tax cut or at the minimum remain revenue neutral.

Thank you again for the opportunity to serve on the House Ways and Means Committee and for taking the time to listen to committee members throughout the 81st Legislative Session. I look forward to continuing our work in the 82nd Legislative Session.

Best regards,

Rep. Ken Paxton
House District 70

Rep. Charlie Howard
House District 26

Rep. Phil King
House District 61

Rep. Larry Taylor
House District 24