HOUSE
RESEARCH
ORGANIZATION bill analysis | 3/9/2005 | HB 3
J. Keffer, et al.
(CSHB 3 by J. Keffer)

SUBJECT: Restructuring the Texas tax system

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 6 ayes — J. Keffer, Villarreal, Grusendorf, Paxton, Smithee, Woolley

2 nays — Luna, Ritter

1 present not voting — Edwards

WITNESSES: *(On original committee substitute:)*
For — Bill Allaway, Texas Taxpayers and Research Association; Glen Rosenbaum, Law Firm Legislative Coalition

Against — Jim Allison, County Judges and Commissioners Association of Texas; Ron Harris, Collin County Judge; Dick Lavine, Center for Public Policy Priorities; Donald Lee, Texas Conference of Urban Counties; Wanda Rohm, National Federation of Independent Business; Susan A. Spataro, Travis County Commissioner's Court, Travis County Auditor's Office; John P. Thompson, Polk County; Frank Turner, City of Plano; Bill Walters, Texas Automobile Dealers Association; Henry Benning

On — Troy Alexander, Speaker's Office; John Heleman, Texas Comptroller of Public Accounts; Steve Riley, Texas Workforce Commission; Byron Schlomach, Texas Public Policy Foundation; Peggy Venable, Americans for Prosperity – Texas; Ray Perryman

DIGEST: CSHB 3 would make several changes to the state's tax and revenue system, including the following, which are analyzed in the pages noted:

- reduction of school property tax rates (p. 5);
- ongoing property tax buy-down (p. 7);
- local taxing unit rate adoption (p. 11);
- real estate sales price disclosure (p. 14);
- reformed franchise tax (p. 17);
- reformed franchise tax enforcement (p. 24);
- sales taxes (p. 27);
- standard presumptive value for vehicle sales (p. 35);

- tobacco taxes (p. 37);
- taxation of non-participating tobacco companies (p. 41); and
- Telecommunications Infrastructure Fund (p. 47).

According to the Legislative Budget Board (LBB), by 2007, the first year that all proposed sections would be entirely in effect, each provision would generate the following amounts of general revenue, with figures in parentheses representing a decrease:

- Sales tax rate increase - $2.24 billion
- Sales tax base expansion - $402 million
- Motor vehicle sales tax rate increase - $481 million
- Boat sales tax rate increase - $8 million
- Cigarette tax rate increase - $749 million
- Cigar and other tobacco rate increase - $20 million
- Snack food and soft drink tax - $248 million
- Repeal of the current franchise tax - ($1.93 billion)
- Reformed franchise tax - $3.38 billion
- Insurance tax credits - ($51 million)
- Telecommunications Infrastructure Fund – $200 million

Unless otherwise indicated, this bill would take effect July 1, 2005, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2005.

SUPPORTERS SAY:

CSHB 3 would provide meaningful tax relief to Texas citizens while ensuring that all Texans pay their fair share for the public services they enjoy. It is a revenue-neutral bill that would provide substantial relief from excessive property taxes for Texas families and businesses. Any net tax increases in the bill would be entirely offset by a reduction in the school district maintenance and operation ad valorem tax rate from $1.50 to $1. This rate reduction would lessen the burden of an onerous tax that increasingly has consumed household incomes and business profits. According to the LBB, CSHB 3 would deliver a $5.63 billion property tax reduction to taxpayers by 2007 and would generate 80,600 new jobs and $4.16 billion in additional personal income for the state by 2010.

The bill would mark a shift toward emphasizing consumption taxes on consumer purchases. Consumption taxes are optional and more fair than inescapable property taxes. The bill also would reform business taxation in the state by repealing the increasingly ineffective franchise tax, which many businesses have been able to avoid. This tax has punished capital- and property-intensive industries and allowed service-based firms to avoid paying their fair share. Instead, CSHB 3 would levy a new franchise tax based on employee wages, a system that would track growth in the state's expanding service sector, thereby providing a stable, increasing revenue source for state services. In addition, with higher taxes on tobacco and snack food, the state would discourage addiction and obesity, leading to healthier citizens and lower long-term medical costs.

OPPONENTS SAY:

CSHB 3 is an unfair bill that would benefit only the most wealthy while forcing the majority of Texans to endure a sizable increase in the taxes they pay, without any net increase in state revenues for the state's many unmet needs. The LBB reports that, on average, every income group below $100,000 would pay a higher share of personal income on taxes, with those at the lowest end of the economic spectrum bearing the highest increase in average tax liability. With the bill's heavy reliance on sales and consumption taxes, only those with incomes over $100,000 would benefit from the bill.

Replacing current revenue from stable property taxes with eroding and volatile sources like sales and tobacco taxes makes little sense fiscally. It also would be unwise to tie the hands of future legislatures by dedicating part of all future state revenue to property tax cuts that primarily would benefit the most wealthy. Further, the payroll tax included in the bill would depress wages, discourage hiring, harm small businesses, and discriminate against labor-intensive industries, potentially devastating many sectors of the Texas economy. While rising property taxes are a serious concern, the solutions provided under this bill would be worse than the status quo.

NOTES:

On March 2, 2005, the House Ways and Means Committee favorably reported the first version of CSHB 3. On March 7, the committee reconsidered its vote and reported favorably a revised committee substitute.

As originally reported, CSHB 3 included the following provisions:

- the ongoing property tax buy-down;
- local taxing unit rate adoption;
- real estate sales price disclosure;

- a reformed franchise tax of 1.1 percent on base wages up to $80,000;
- reformed franchise tax enforcement;
- changes to sales tax rates and exemptions, including a general state sales tax rate of 7.2 percent;
- standard presumptive value for vehicle sales;
- increases in tobacco taxes; and
- raising the current cap on the Telecommunications Infrastructure Fund (TIF) from $1.75 to $2 billion and extending the fund two years to September 1, 2007.

In addition, the bill as originally reported would have been contingent on enactment of HB 2 by Grusendorf.

CSHB 3 as finally reported made the following changes to the substitute originally reported:

- added a provision to reduce the school district M&O property tax cap from $1.50 per $100 valuation to $1 per $100;
- increased the rate of the reformed property tax to 1.15 percent and the wage cap to $90,000;
- increased the general sales tax rate from 7.2 to 7.25 percent;
- repealed the exemption from sales taxes for newspapers;
- introduced a 3 percent tax on snack food and soft drinks;
- introduced a provision to tax non-participating tobacco companies; and
- eliminated the cap on TIF and extended the fund to September 1, 2011.

The revised committee substitute also included provisions to allow sections to take effect at an earlier date if the bill finally was passed by two-thirds of both houses of the Legislature.

According to the LBB, the bill would have a positive impact of $11.77 billion to general revenue-related funds through fiscal 2006-07 if it went into effect on July 1, 2005. The bill would have a positive net impact of $10.94 billion to general revenue-related funds through fiscal 2006-07 if the effective date was September 1, 2005. Nearly all of this total would offset the reduction of local property taxes by one-third, with a net increase of approximately $214 million in fiscal 2007.

PROPERTY TAX RATE REDUCTION

BACKGROUND: Under Education Code, sec. 45.003(d), a school district may levy taxes of up to $1.50 per $100 valuation of taxable property in the district for the maintenance and operation of public schools. By special law, certain districts in Harris County may tax above this cap.

DIGEST: CSHB 3 would amend Education Code, sec. 45.003(d), to cap school district ad valorem tax rates at $1 per $100 valuation of taxable property. An election held before September 1, 2005, that authorized a rate of at least $1 would be sufficient to authorize a rate no greater than $1 per $100 of valuation. A district now allowed by special law to impose a rate greater than $1.50 could continue to impose a rate that was 50 cents less than the rate previously authorized.

SUPPORTERS SAY: A one-third reduction in the school property tax rate would provide meaningful relief to all Texans. Homeowners would enjoy reduced property tax bills, and the market would ensure that renters benefit through lower rents from savings received by apartment property owners. Consumers would see lower prices for goods and services made possible as businesses realize the property tax savings under this bill.

Property taxes have increased dramatically in recent years. Numerous indices show that the property tax burden in Texas is among the highest in the country. High property taxes are difficult to bear for many homeowners, particularly the elderly and those who live on fixed incomes that do not keep pace with rapidly rising property tax appraisals. School districts account for about 60 percent of property tax levies. Reducing this rate substantially would relieve the property tax burden for families and businesses across the state.

In the new system, the state share of public education funding is projected to reach about 60 percent, compared to less than 40 percent in the current system. New state revenue generated by CSHB 3 would replace school property taxes, and HB 2 by Grusendorf would boost state education spending overall. A lower cap on school property taxes would prevent school districts and the state from becoming overly dependent on increases in local property values for school funding. This change would bring more equity to the state's school finance system because districts would be less dependent on local property bases of widely varying value and a larger share of education dollars would flow through the state funding formulas.

Texas citizens would be better off paying a higher sales tax that partially offsets a property tax reduction. While a higher sales tax causes people to make choices about non-essential spending and contains exceptions and exemptions for essential items such as food and medicine, high property taxes leave many citizens little choice but to sell the homes they inhabit because they no longer can afford to pay the taxes owed on them.

While some argue that partially replacing property taxes with other business taxes would hurt business and the Texas economy, it is worth remembering that businesses shouldered approximately 42 percent of the local property tax burden in 2003. Property tax relief would benefit virtually all Texas businesses even if other taxes must be raised to offset the lost property tax revenue.

OPPONENTS SAY:

While CSHB 3 would lower school property tax rates, this would amount to a "tax shift" rather than a true tax cut. The property tax cuts in CSHB 3 would be achieved not by fiscal restraint and improved efficiency but by creating new taxes and raising existing rates. The methods for reducing property taxes would include a new tax on business payrolls that would be a "job killer." Merely reshuffling the tax burden in the state would make little economic sense.

CSHB 3 would raise taxes for the majority of Texans in order to reduce school property taxes primarily for the benefit of the most wealthy. This property tax cut largely would be funded through a 1-cent increase in the state sales tax to 7.25 percent, a rate that would give Texas the highest state sales tax in the nation. Because of this and other regressive taxes included in the bill, the LBB's tax equity note on CSHB 3 shows that 80 percent of Texas families would see an increase in total taxes as a result of this bill. Those with the lowest incomes would pay the largest portion of new taxes as a percent of income, while only the 20 percent of families with incomes over $100,000 would benefit from the bill. The Legislature should try to reverse what already is an extremely regressive tax system rather than move the state even further in the wrong direction.

The federal government has a longstanding policy allowing homeowners to deduct property taxes from their federal income taxes. Recent legislation allowing taxpayers to deduct sales taxes on federal returns is due to expire after the 2005 tax year, so the state would be trading a deduction that may expire for one that is virtually certain to continue.

There is no reason to believe that landlords automatically would lower rents to reflect property tax savings received through this bill. At best, this bill might make it easier for landlords to lower rents in response to market forces that actually do affect rent prices, such as the overbuilding of rental units in a given area.

Funding public education through local property taxes is essential to maintaining the accountability of school districts to local citizens. The Legislature should exercise care in placing too much responsibility for funding public schools with the state rather than with local taxpayers.

OTHER OPPONENTS SAY:

Reducing school property taxes by the amount proposed is not worth jeopardizing the economic health and stability of Texas. Instead, the Legislature should raise the sales tax, which taxes voluntary consumption, and grant a reasonable amount of tax relief to property owners, thus making the harmful payroll tax unnecessary.

If the Legislature wants to provide meaningful property tax relief to those who need it most, it would be more effective to increase the homestead exemption than to cut the property tax rate. This could provide more substantial relief as a percentage of tax burden to lower- and middle-income families than would a 50-cent rate reduction, ameliorating some of the regressivity of the bill.

ONGOING PROPERTY TAX BUY-DOWN

BACKGROUND:

Art. 3, sec. 49a(a) of the Texas Constitution requires the comptroller of public accounts to issue an estimate of revenue available for spending – the Biennial Revenue Estimate (BRE) – before each regular legislative session. The comptroller must issue supplemental estimates before each called session and may issue estimates at other times to show probable changes. No bill appropriating money may be sent to the governor unless the comptroller certifies that the proposed spending is within the amount of estimated revenue available at the time of certification.

DIGEST:

CSHB 3 would require that 15 percent of any increase in available state revenue be dedicated to reducing school maintenance and operation

(M&O) tax rates. In addition, an amount equal to the prior biennium's distribution also would be dedicated to school property tax reduction in the next biennium. Available state revenue would include state revenue from any source, excluding federal funds and funds constitutionally dedicated to a particular purpose. The increase in available state revenue would be the amount by which estimated revenue in the comptroller's BRE for the succeeding fiscal biennium exceeded estimated revenue in the BRE for the current fiscal biennium.

The comptroller would distribute the funds in equal amounts in each year of the biennium equally apportioned to reduce each district's M&O tax rate. A district's M&O rate could not be reduced to less than 75 cents per $100 of taxable value. The bill would require that funds be applied to reducing the local tax rate and would hold districts harmless after any distributed tax rate reduction by requiring additional state aid to the extent that a district was not compensated for a reduction in its ad valorem tax. It also would include the distribution in the calculation for a local tax rollback election.

This section would take effect January 1, 2006, and would apply to an ad valorem tax year that began on or after that date.

SUPPORTERS SAY:

Texas should develop a mechanism to continue lowering school tax rates and increasing the state share of education costs, thereby promoting greater equity. Offering property tax relief by lowering the cap on school M&O taxes would be a good start, but a statutory mechanism would better ensure that school districts and homeowners do not later find themselves in the same position they are in today. Counting on future budget writers to pay for a higher state share is unrealistic, so CSHB 3 would make automatic continued progress toward that goal by making it a statutory priority.

This proposal would put property tax reduction first. A wide range of interests compete when the state has additional money, including health programs, roads, economic development projects, and education. Requiring that a portion of any revenue increase go toward reducing the school tax rate would put property tax reduction at the top of the list, while preserving most of any state revenue increase for other priorities, including increases in education spending.

Placing the school property tax buy-down mechanism in statute rather than in the Constitution would save the state from a financial bind if unforeseen circumstances made it impossible to meet state obligations and still dedicate 15 percent of any state revenue increase to school tax rate reduction. A constitutional mandate would be difficult for future lawmakers to override because it would require two-thirds legislative adoption and voter approval. Because a statutory limit would require only majority-vote approval of a statutory amendment to delay implementation, it would give lawmakers needed flexibility.

This mechanism would ensure that if new state tax efforts raised more money than expected, some of the new money still would go toward continued school tax rate reduction and an increased state share of overall education spending. Estimates of how much additional revenue the proposed changes to the Tax Code in CSHB 3 may generate could be conservative and lead to a windfall in future years. To ensure that all of any new money does not get spent by the state for purposes other than school tax relief, this provision would ensure that at least 15 percent of it was returned to local taxpayers every biennium.

The definition of "available state revenue" in CSHB 3 would not encounter the same problems as a similar mechanism in CSHJR 1 by Grusendorf, the constitutional amendment proposed during last year's special session. That definition would have calculated growth in revenue between the prospective biennial revenue estimate for the next biennium and the one for the current biennium made two years earlier. This proposal would calculate any revenue increase based on the difference between the prospective biennial revenue estimate for the next biennium and the comptroller's estimate of state revenue for the current biennium made at the same time as the prospective estimate. This would account for any actual increase or decrease in state revenue estimated shortly before each regular session begins.

OPPONENTS SAY:

This proposal would create a budget structure at odds with the state's economy by dedicating 15 percent of any state revenue growth to replacing school property taxes before the Legislature even had the opportunity to review state spending needs and priorities for the next biennium. The primary drivers in the state budget are not new programs but population growth and inflation. Under the current system, available state revenue generally grows with the economy. For example, the comptroller's BRE for fiscal 2006-07 was about $10.6 billion in general revenue over that for the previous biennium. However, after accounting for baseline budget needs, the extra growth was only $400,000. If this provision had been in place, the state would have been short $1.2 billion just to fund current services.

This proposal would not add any more money to education. By offsetting local property taxes, it merely would replace one revenue source with another. The current system allows budget writers to appropriate large portions of additional general revenue to education. On average for the last five biennia, the Foundation School Program has received 30 percent of general revenue in excess of the previous biennium – for every new general revenue dollar the state has brought in, 30 cents has gone toward education. This proposed property tax buy-down would make it more difficult to appropriate new dollars to education because any net increase in education spending would have to be made after school property tax reduction already has taken a substantial slice of any extra revenue available.

This provision would deplete growth in state finances and be a fiscal albatross in periods of declining revenues. It would require the comptroller to distribute 15 percent of the increase in state revenue plus the amount distributed in the preceding biennium. This would be an ever-increasing portion of new state revenue going toward property tax reductions rather than other state needs. Without an overall cap on the percentage or amount of new revenue this could tie up, legislative budget writers could be forced into a strait jacket even as population demands rose and costs increased. In times of declining revenues, the effect would be even more profound, with the state locked in to using a large portion of its available revenue for school tax cuts.

This provision would take funding from programs that help children and needy Texans and give it to businesses and property owners. Local taxpayers and businesses would benefit the most from this provision because it would take revenue generated by the state from a variety of sources and give it back only to property tax payers. Meanwhile, children who benefit from public education and the Children's Health Insurance Program and needy Texans who benefit from other state programs would not benefit at all. Even though all Texans pay into state revenue through sales taxes, fees, and other consumption taxes, only a few would really benefit from this provision.

The appropriations process works without hamstringing budget writers. According to the analysis in the governor's 2004 school finance plan, it took almost a decade for average school M&O tax rates to rise from an average of $1.17 in 1993 to $1.43 in 2002. The creep in growth is so slow that it could be replaced each biennium through the appropriations process. While earlier surpluses may not have gone to fund property tax relief, current and future budget writers have the authority to address this through the appropriations process without having their hands tied.

The definition of "available state revenue" used to reduce school property taxes is too broad. Because the proposal's definition would include all funds from any source except federal and constitutionally dedicated funds, one third of the increase of other dedicated funds, such as lottery funds, bond funds, and college tuition, could have to be spent on property tax relief. Few funds are constitutionally dedicated, which could leave them open to diversion from their intended purpose.

OTHER OPPONENTS SAY:

This proposal should be in the form of a constitutional amendment, rather than a statute, to ensure that future lawmakers do not make a practice of suspending the dedication whenever it is convenient for them. A simple majority vote would be too low a hurdle for circumventing such an important part of the tax relief package.

NOTES:

The bill as filed contained no similar provision. It was included in the committee substitute first considered by the House Ways and Means Committee, but was amended by the committee to remove the floor of 75 cents for the rollback and add authority for the commissioner of education to distribute the rollback funds. It also stated that HB 2 by Grusendorf or similar legislation would prevail in case of any conflict. The committee substitute that finally was adopted eliminated the committee amendment.

LOCAL TAXING UNIT RATE ADOPTION

BACKGROUND:

The "truth-in-taxation" provisions in Ch. 26 of the Tax Code require most taxing entities to publicize proposed ad valorem tax rates and hold public hearings before adopting the tax rates.

Most taxing entities are required to calculate an effective tax and a rollback tax rate. Under chap. 26, sec. 26.04, the effective tax rate is the rate that if levied on the value of property for the current year would raise the same amount of revenue using the value of property for the previous year. If property values increase from one year to the next, the effective tax rate will be lower than the actual rate.

The rollback tax rate is the maintenance and operations (M&O) rate that would raise the same amount of revenue using the current year's property tax base as the previous year's base, plus 8 percent, plus any additional rate required for debt service. The rollback rate permits a maximum 8-percent increase above the effective M&O rate, except for school districts, which may increase the effective rate only by 6 cents per $100 of property value.

Under ch. 26, sec. 26.05, if a taxing unit intends to adopt a proposed tax rate that exceeds the lower of the rollback rate or 3 percent above the effective rate, its governing body must provide the public with published notice of the date, time, and place of the public hearing on the proposed tax rate, hold the public hearing, publish another notice of the public meeting for the vote on the proposed rate, and then vote to adopt the rate. If the proposed rate does not exceed the rollback rate or 103 percent of the effective rate, then no special meeting or newspaper notice is required. If a taxing unit adopts a tax rate that exceeds the rollback rate, the levy is subject to a rollback election upon petition and public vote. If voters do not approve the increase, the rollback rate applies.

DIGEST: Effective September 1, 2005, CSHB 3 would apply the notice and hearing requirements for adopting a tax rate if the proposed tax rate exceeded the lower of the rollback rate or the effective rate, repealing the 3 percent allowable increase in the effective tax rate.

SUPPORTERS SAY: CSHB 3 would strengthen the truth-in-taxation provisions by requiring a local taxing unit to notify the public, call a public hearing, and vote on any increase beyond the effective tax rate. It would provide a clearer and more open process. Taxpayers would benefit from this more transparent approach because local officials would have to expose any proposed increase in the effective rate to a process that would ensure public notice.

CSHB 3 would hold local elected officials responsible for raising additional revenue. Local taxing units could leave their tax rates constant yet raise more revenue from local taxpayers because property values increased. The effective tax rate takes these higher values into consideration. Requiring notice and a special vote for any increase beyond the effective rate would provide greater accountability.

Cities and counties would not be fiscally constrained by CSHB 3. Local taxing units already are required to publicize their tax rates in most cases. CSHB 3 would not limit revenue-raising ability any more than is currently permissible because the calculation of the effective tax rate and rollback rates and procedures would not change.

The city of Lubbock already follows this truth-in-taxation procedure. Rather than accept a windfall from increases in appraised values and allow what amounts to a hidden tax, the city automatically lowers its tax rate in order to generate the same amount of revenue as the year before. The city council has an open, separate vote on whether to adopt any tax rate beyond the effective rate if it believes that more revenue is justified.

OPPONENTS SAY:

Publicizing a routine tax adoption and following special procedures would cost local governments time, effort, and money. Current law builds in a buffer for a 3 percent increase beyond the effective rate, allowing local taxing entities to handle routine adjustments for higher property values. CSHB 3 would force most taxing units to jump through more procedural hoops to adopt their annual tax rate even when any revenue increase would be minimal.

CSHB 3 would contribute to a public perception that cities and counties are never justified in raising taxes and that all tax increases are unfair. Cities and counties, which rely heavily on property taxes, must raise enough revenue to support growing populations, demands for essential services, and unfunded state mandates to which local governments must be responsive. When the public demands expanded or improved services, local government cannot always avoid increased taxes.

OTHER OPPONENTS SAY:

While CSHB 3 would open the process of adopting local property tax rates for any increase beyond the effective rate, it would not provide meaningful relief to taxpayers faced with appraised values that are rising rapidly in many parts of the state. Most citizens do not pay attention to the published effective rate or public notices, nor do they attend public hearings. CSHB 3 would allow elected officials to retain too much leeway to raise tax rates beyond the effective rate and reap the revenue from rising values.

Caps on revenue raised from local property taxes would be a more effective way to limit automatic revenue increases from higher appraised values. Another option would be to lower the rollback rate and trigger automatic elections when the adopted rate exceeded the rollback rate, rather than requiring voters to petition for a rollback election. An automatic rollback election would require taxing units to justify directly to the voters any significant revenue increase derived from higher property values. Still another way to ensure that rising appraised values create less of a burden for taxpayers would be to lower the current 10 percent cap on appraised value increases. All of these methods would be more effective constraints on local taxing units benefiting from a revenue windfall from rising property values than merely requiring them to follow a few extra procedures before they adopt tax rates above the effective rate.

NOTES: HB 3 as introduced did not include any provisions related to truth in taxation. The original version of the substitute considered by the Ways and Means Committee would have lowered from 8 percent to 3 percent the increase allowed in the rollback rate before an election could be triggered. It would have triggered an automatic local election if local governing bodies, other than school districts, increased the effective rate by more than 3 percent a year, rather than requiring a voter petition. The committee amended the original substitute to delete this provision and add the requirement that the truth in taxation provisions would apply when governing bodies other than school districts proposed to adopt any tax rate higher than the effective rate, repealing the allowable 3 percent increase.

REAL ESTATE PRICE DISCLOSURE

DIGEST: Effective September 1, 2005, CSHB 3 would add Subchap. D to Ch. 22 of the Tax Code, requiring a real estate buyer or grantee to file a sales price disclosure report following the sale or transfer of real property within three days after the deed was recorded. The report would have to be filed with the chief appraiser of the appraisal district for the county in which the property was located. A chief appraiser could use information included in this report in determining the market value of a property but could not increase the market value solely on the basis of this information.

A chief appraiser could bring action for an injunction in court to compel the filing of a sales price disclosure report. The court could order a person to comply and assess costs and attorney’s fees against that person.

Several exceptions to the reporting requirement would be allowed, including if the sale was in response to a court order or in lieu of foreclosure, made by a bankruptcy trustee, made under a deed of trust, made by one co-owner to another, or made to a spouse, child, or parent.

The bill specifies the information that would be required on a sales price disclosure report, including:

- the names of the seller and purchaser;
- a description of the property;
- the sales price of the property; and
- the method of purchase.

The form also would state that making a false statement on the form would be a class A misdemeanor (up to one year in jail and/or a maximum fine of $4,000) or state jail felony (180 days to two years in a state jail and an optional fine of up to $10,000). A buyer’s agent, lender, insurance company, or attorney who prepared a report would not be liable for unintentional errors or omissions.

Each appraisal district would have to make report forms available and allow filing by mail or hand delivery. Chief appraisers would have the option of accepting the report by fax or electronic submittal. Upon receipt of the form, the chief appraiser would provide the filer with written acknowledgment of its receipt.

Confidentiality. A report filed under this bill would be confidential and available for disclosure only to an appraiser. Exceptions under which the information could be disclosed would include judicial or administrative subpoena of the records, disclosure to the purchaser, the comptroller, or local appraisal district, a taxation proceeding involving the purchaser of the property or the appraisal district’s appraisal process relating to a similar property, for anonymous statistical purposes, for reports required of the appraisal district, or for the collection of delinquent taxes.

Unauthorized disclosure would be a class B misdemeanor (up to 180 days in jail and/or a maximum fine of $2,000).

CSHB 3 also would keep confidential, except for official use, a photograph or floor plan of a property improvement that was designed for human residence, including a residence homestead.

SUPPORTERS SAY:

Chief appraisers need mandatory real property sales price disclosure, which Texas, unlike at least 35 other states, does not require. Not knowing how much buyers pay for property inhibits the ability of appraisers to appraise it at full market value as required by law. The sales price is the best measure of a property's value. Having access to it would enhance equity in the appraisal process.

Mandatory disclosure would be aimed at acquiring undisclosed sales prices of commercial property, the sales terms of which usually are kept between the parties, and of high-dollar homes, which may never be put on the open market and the sales prices of which often are contractually concealed. Although they may represent only 20 percent of taxable real estate, these properties represent millions of dollars in untaxed value. In fairness to other taxpayers, the full value of these most expensive properties should be reflected on the appraisal rolls.

OPPONENTS SAY:

Property owners and realtors already are providing 80 percent of sales price data from the multiple listing service (MLS) through agreements with local officials authorized as part of property appraisal reforms of the late 1970s. Appraisers are trying to use the law to obtain what they have been unable to negotiate.

Mandatory disclosure is an unnecessary infringement on property owners' privacy and a violation of the proprietary rights of realtors to use the MLS, which is not readily available to the general public. Mandatory disclosure of commercial and industrial property sales prices could lead to divulging information about products or processes that could put businesses at a competitive disadvantage.

Sales prices can be misleading because they often are influenced by non-market factors not readily apparent without comprehensive analysis.

OTHER OPPONENTS SAY:

The ostensible purpose of disclosure is to provide appraisers with sales prices for more accurate value appraisals. This bill would give them much more data than is necessary.

A buyer of real property might not be aware of the sales price disclosure obligations under this bill and may fail to prepare the report on time. This particularly would be a problem for an individual who completed the sale without aid from a real estate agent, title insurance company, or lender.

The bill should include a mechanism by which the state or the local appraisal district makes known the requirements of this bill to potential property buyers.

REFORMED FRANCHISE TAX

BACKGROUND: Tax Code, ch. 171 imposes the corporate franchise tax, Texas' primary business tax, in exchange for granting the privilege (franchise) of doing business in Texas. The tax applies only to for-profit corporations and, since 1991, to limited liability companies (LLCs) chartered or organized in Texas, as well as to foreign corporations and LLCs based or doing business in the state. As such, franchise taxpayers include professional corporations, banks, savings and loan associations, state-limited banking associations, and professional LLCs, but not limited partnerships, sole proprietorships, or non-corporate associations.

Insurance and open-end investment companies (e.g., mutual funds) and most non-profit corporations are excepted, as are corporations with gross receipts less than $150,000 and firms owing $100 or less in tax. Major exemptions and exclusions include interest earned on federal securities, business loss carryover, and officer/director compensation paid by companies with 35 or fewer shareholders.

A dual calculation method determines the amount of tax liability. Taxpayers pay the greater of a 0.25 percent tax on taxable capital (assets' net worth) or a 4.5 percent tax on earned surplus (modified net income). The income component generates the most revenue and is paid by about 75 percent of franchise taxpayers.

In fiscal 2004, the franchise tax made up about 6.5 percent of state tax revenue and 3 percent of total state revenue, generating more than $1.8 billion. This was a 6.9 percent increase from fiscal 2003, slightly less than the 8 percent overall increase in state tax revenue. The Comptroller's Office has estimated franchise tax revenues for the fiscal 2005-06 biennium at more than $3.79 billion, a 3.9 percent increase from fiscal 2004-05. Franchise tax payments are due on May 15 of each year, and all revenue goes into the general revenue fund.

Insurance Code, ch. 4 imposes insurance premium taxes on the amount of gross premiums written by insurance companies, with the rates varying depending on the type of insurance. Property and casualty insurance is taxed at a 1.6 percent rate, title insurance at a 1.35 percent rate, and life, accident, and health insurance at a 1.75 percent rate, which also applies to HMO gross revenues. Seventy-five percent of insurance premium tax revenues go in to the general revenue fund, and 25 percent goes into the foundation school fund. In fiscal 2004 the state collected $1.2 billion in insurance premium taxes.

DIGEST: CSHB 3 would repeal the current franchise tax and replace it with a "reformed franchise tax" on businesses that employ individuals who work in the state. This reformed franchise tax would be charged to employers at a rate of 1.15 percent for each calendar quarter on the wages of each employee. The wage base taxed could not exceed $90,000 per calendar year (a maximum of $1,035 per employee per year). Proceeds from the reformed franchise tax would go into the general revenue fund.

Employers required to contribute to the Texas Workforce Commission's Unemployment Compensation Fund would be liable for the tax. They would be liable regardless of whether their employees were full time or part time or how long they received wages during a quarter. The tax would be due at the same time and collected in the same manner as contributions assessed under the Unemployment Compensation Fund. To the extent practicable, the Workforce Commission would combine the reporting and payment of unemployment compensation contributions with the reporting and payment of the tax. A report on wages would be due from each employer on or before the last day of the month immediately following each calendar quarter.

Each business would be taxed for each employee who performed a service for that business for compensation. It would not matter whether the business paid a contribution for a calendar quarter for the employee if the individual was an employee of the business for any part of the calendar quarter. An individual would be an employee of a business if the business directed how that person performed the service for which the person received compensation. The bill specifies factors that could be used to identify such a relationship.

Taxing services performed outside the state would be based in part on whether services were "localized" in Texas or in another state. "Localized" would be defined as service performed entirely within the state or when the service performed outside the state was incidental.

The tax would apply to wages for a service performed in or partially in and partially outside the state if the service was localized in Texas. If such a service was not localized in Texas or any other state, the tax would apply if at least some of the service was performed in this state, and:

- the operations were based or services controlled from within Texas; or
- if neither the operations were based nor were the services controlled from within this state, but the person performing the service was a resident of this state.

Wages would be used for the tax calculation for a service performed anywhere in the United States, including entirely outside Texas, if:

- the service was not localized in a state;
- it was performed by a person required to travel outside the state in performance of his or her duties; and
- the operations were based or services controlled from within this state.

The tax would apply to wages for services performed outside the United States by a U.S. citizen.

Businesses would be prohibited from deducting this tax from employee wages, and doing so would be a class A misdemeanor (up to one year in jail and/or a maximum fine of $4,000). Deducting the tax from an employee's wages would be subject to a civil penalty up to $500 and could be assessed for each violation. A person who did not pay the tax on an individual's wages would be liable to the state for a civil penalty equal to twice the amount owed for those wages unless the person could demonstrate a reasonable basis for determining that the individual was not considered an employee under this bill. The attorney general would file suit to collect penalties.

Governmental entities and organizations exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code would be exempt from the tax.

A taxable business that paid any insurance premium taxes under Insurance Code, ch. 4 would be entitled to a credit against those payments for the entire tax paid under the reformed franchise tax. Such a business could not receive a credit exceeding the tax due after applying other credits. Unused credit could be carried forward for up to five years.

A taxable provider of health care services that participated in either Medicaid or Medicare and received 15 percent of its revenue from those programs during a calendar quarter could receive a credit for that quarter against taxes imposed under the reformed franchise tax. The amount of credit would be 40 percent of the total payments the provider received under Medicaid and Medicare during that calendar quarter.

The credit received could not be more than the tax due after applying other credits. A business participating in Medicaid or Medicare that provided pharmaceuticals or medical equipment could not count payment for those services under the credit.

The bill contains provisions that would transfer businesses from payment of the current franchise tax to the reformed franchise tax. This section would take effect January 1, 2006.

SUPPORTERS SAY:

The franchise tax has become a voluntary and divisive corporate income tax and should be replaced with a fairer, more broadly based business levy. Since 1985, the number of taxable entities has decreased 13 percent while business activity has doubled, and the number of firms using non-corporate structures is up 500 percent. As of 2001, of the about 500,000 firms subject to the tax, fewer than one third actually owed any taxes, according to the Comptroller's Office. Roughly one in six Texas firms pay franchise tax. It no longer tracks growth in the state's economy, mainly because the burgeoning service sector uses business structures not subject to the tax. Avoidance has become commonplace, especially among large corporations that have restructured themselves as out-of-state partnerships to take advantage of the so-called "Delaware sub." Closing that loophole is made problematic by legitimate out-of-state partnerships doing business in Texas that never have paid the tax. Even if that problem were corrected, the franchise tax has other loopholes.

Rather than try to plug this leaky fiscal dike, the state should scrap the franchise tax for a reformed franchise tax based on the wages of employees of Texas companies. This would raise about $3.4 billion in state revenue annually by 2007, according to the Legislative Budget Board. A broad-based, low-rate tax on businesses based on their wages would track economic growth and help the state deal with inflation. The

revenue source would be predictable, and the revenue stream relatively stable. Fairness would be assured by creating a broad tax base based on the existing system for paying unemployment compensation fund contributions and levying each taxpayer at the same rate per employee. Instead of paying the greater of two calculations, as in the franchise tax, businesses' tax burden would be ameliorated by paying quarterly the ratio of 1.15 on a base up to $90,000 per employee per year. This would balance the state's revenue needs with the cost of doing business.
Using the existing unemployment fund contribution collection structure without major systemic changes would simplify administration. The Comptroller's Office would collect the tax from virtually all employers and out-of-state companies whose employees work in Texas, as well as companies whose employees work elsewhere but live in the state.

Monitoring compliance would be relatively easy because the Texas Workforce Commission, which already collects employers' unemployment fund contributions, requires reports that could be used for this purpose. Unlike the existing franchise tax, the reformed franchise tax would require minimal additional paperwork, unintrusive auditing, and easy calculation, reducing accounting expenses. The business expense created by the tax would be predictable, controllable, and federally deductible.

It is unlikely that a wage-based reformed franchise tax would be construed as an income tax under the Constitution because wages themselves would not be taxed but would serve only as the basis for calculating the business tax. Even if the reformed tax did not apply to sole proprietors or partners, replacing the current franchise tax with a payroll-based tax still would realize a net gain to the state of about $1.5 billion a year, according to the LBB.

Small businesses benefit from public programs and services and, depending on their structure, from privileges granted by state government. They should have to share the costs of the benefits they get from doing business in Texas in proportion to their ability to pay.

Capping the wage bases eligible for taxation at $90,000 per employee per year would be necessary to maintain Texas' favorable business climate. State policy should reflect a desire to encourage the growth of high-paying jobs, and CSHB 3 would be consistent with that goal.

Exempting insurance companies is necessary to protect Texas insurers from having to pay higher taxes in other states. State policies governing the insurance industry are characterized by retaliatory taxes, under which Texas companies operating out of state are taxed at a level reflecting the rate at which Texas taxes out-of-state insurers in Texas. Insurance providers already pay what is in effect a gross receipts tax on their premiums, and applying the reformed franchise tax to them would amount to double taxation.

The credit for providers of health care services under the Medicare and Medicaid programs would serve an important policy goal of encouraging participation in these programs by health care providers. While for-profit health care providers should be required to pay the reformed franchise tax, the state also should recognize that the compensation rate for Medicaid and Medicare is between 40 percent and 60 percent of the market rate for these providers. Thus, a credit for those who serve a significant portion of these partially funded cases would prevent excessive taxation of those providers.

OPPONENTS SAY:

A payroll tax like the one included in CSHB 3 would be bad for workers, onerous on labor-intensive industries, and potentially harmful to the state's fragile economy. It would cost jobs by encouraging employers to reduce workforces. A payroll tax would depress wage levels by giving employers an incentive to reduce or not increase them, artificially hindering income growth. This would create a particular inequity for low-income workers, who could less afford to have their wages held down, and could have a negative economic impact in areas with high concentrations of these workers.

Basing business taxation on payrolls could create inequities not only between low-wage and higher-wage workers, but among similarly situated firms. It is not difficult to envision two companies with the same gross receipts and same number of employees, but markedly disparate wage scales, paying much different tax bills.

Taxes based on wages penalize labor-intensive businesses and industries, raising issues of fairness and equity vis-a-vis capital-intensive firms or those with lower labor costs. This would discourage the attraction of high-paying jobs, which can undermine economic development.

Payroll taxes also may discourage hiring and pay raises in general. Tax revenue generation may be harmed by increased unemployment, especially in industries with cyclical hiring patterns or businesses susceptible to high turnover rates. Payroll taxes are not linked to the ability to pay because they are based on business expenses, not business revenue. Consequently, they reflect investment but not profitability and could have more severe effects during economic downturns.

A payroll tax would shift the state’s tax burden significantly onto business at a time when the Texas economy has not fully recovered from a recession. This tax would hit hardest the service industries, which create many jobs but less direct wealth than do oil, gas, agriculture, and manufacturing. CSHB 3 would mean an even bigger shift in the business tax base from capital intensive industries, much of whose wealth is property-based, to service businesses because any revenue gain from the payroll tax would be used solely to offset taxes on property.

A payroll tax may not solve the structural problem in the franchise tax base. Not only might it not apply to sole proprietors, depending on whether they are deemed employees, it also might violate the constitutional ban on taxing income, depending on whether partners must pay the tax on their compensation. If they did not, a payroll tax could contain a new tax-avoidance loophole by creating an incentive to form sole proprietorships or partnerships.

Taxing medical services under the reformed franchise tax would represent a dramatic and detrimental policy shift for the state. Spiraling health care costs already are a severe problem, and CSHB 3 would only exacerbate this trend. Given the different compensation rates for Medicaid and Medicare, it would inappropriate to lump them together when determining eligibility for this credit. Health care has been one of the few truly consistent bright spots for the state's economy, and it would make sense to exclude providers from this payroll tax altogether to encourage growth in this sector. The state has better ways to encourage participation in Medicaid by providers than with this tax credit, including increasing the compensation rate for that program.

OTHER OPPONENTS SAY:

Despite some volatility due to base erosion and avoidance, the franchise tax has remained stable during the recent economic downturn, especially compared to other states’ corporate taxes. Before embarking on an unproven fiscal venture, the state should reform the franchise tax and broaden it to apply to more, if not all, businesses regardless of structure.

A better option would be to replace the income component of the franchise tax calculation with a 2.5 percent tax on adjusted wages. It would apply to all for-profit businesses paying at least $250,000 a year in wages. Doing so would not only close the so-called “Delaware sub” loophole but expand the tax to include sole proprietors and partnerships, generating $5 billion a year in net revenue.

A broad-based, low-rate business activity tax would be better than a payroll tax. It would be fair and equitable, grow with all sectors of the economy, and avoid constitutional issues raised by levying payroll taxes on partners and sole proprietors.

The payroll tax should include a small business exemption so as not to inhibit entrepreneurs or harm “mom and pop” operations and a tiered rate system to protect businesses and individuals with low profit margins.

To ensure a broad base for the new franchise tax and as low a rate as possible, the current wage base cap of $90,000 should be eliminated. The tax would be regressive, given that beyond the $90,000 cap businesses would pay a declining rate on employee wages. For the sake of tax equity, this part of the bill should be eliminated with an offsetting cut in the tax rate.

Quarterly tax payments are burdensome, especially for small businesses. A mechanism or fee for annual payments, or an alternative annual tax, should be included.

The charitable organization exemption should include non-profits statutorily exempt in Texas that are not exempt under sec. 501(c)(3) of the federal tax code.

REFORMED FRANCHISE TAX ENFORCEMENT

BACKGROUND: Tax Code, ch. 171 imposes a franchise tax on corporations and other corporate structures doing business in Texas. The statute also contains enforcement mechanisms for the comptroller and the secretary of state to collect delinquent franchise and other state taxes.

The state grants charters that allow Texas based companies to do business in Texas. Out of state companies receive certificates of authority. Corporate privileges include limited liability protection for officers and directors and the right to file lawsuits and defend themselves against lawsuits in state court.

DIGEST:

Effective January 1, 2006, CSHB 3 would require the Comptroller's Office to forfeit the corporate privileges of corporations, business entities qualifying for state liability protections, and non-corporate entities subject to state taxes that did not file required reports or did not pay state taxes or penalties imposed within 45 days of notice of forfeiture. Such entities could not file lawsuits or defend themselves in court, other than against lawsuits to forfeit their charters or certificates of authority.

Notice of forfeiture. The comptroller would have to notify an entity in writing that forfeiture would occur without a judicial proceeding unless the entity filed delinquent reports or paid delinquent taxes or penalties within 45 days. The filed notice and record of mailing would constitute legal notice of forfeiture. The comptroller would have to restore privileges if, prior to forfeiture, the entity paid any taxes, penalties, or interest due.

Directors or officers would be liable for their entities' debts incurred in Texas after reports, taxes, or penalties were due and before privileges were restored. Liability would be the same as for a partner in a partnership. Individual liability could be avoided by showing that debts were incurred over the individual's objections or without the individual's knowledge and that reasonable diligence would not have revealed intent to create the debts. Liability would not be affected by restoration of forfeited privileges, charters, or certificates of authority.

Entities whose privileges had been forfeited could not receive affirmative relief in lawsuits involving acts that occurred prior to forfeiture unless their corporate privileges were restored.

Texas-based banking corporations and savings-and-loan (S&L) associations (both state and federally chartered) would be exempt from forfeiture. The state banking or S&L commissioners would have to appoint a conservator to pay the delinquent taxes of a bank or S&L.

Forfeiture of charter or certificate of authority. Failure within 120 days of forfeiture to pay requisite amounts would be grounds for forfeiture of corporate charters and certificates of authority. After 120 days the comptroller would have to certify the names of entities to the attorney general and the secretary of state. The attorney general then would have to file suit to forfeit each entity's charter or certificate of authority if grounds existed. The secretary of state would have to record forfeitures granted by district courts, appeals, and final dispositions upon receipt of judgments and certifications. Courts would be able to place entities undergoing forfeiture in receivership.

Upon receipt of the comptroller's 120-day certification, the secretary of state could forfeit an entity's charter or certificate of authority, without judicial proceedings, if it did not restore its privileges within 120 days after forfeiture and the entity had no assets with which to pay judgments for any taxes, penalties, or court costs imposed. The secretary of state would have to note the forfeiture in the entity's records. Stockholders, directors, or officers of entities when they underwent forfeiture could request the secretary of state to set aside the forfeiture of charters or certificates of authority. The secretary of state would have to set aside such forfeitures if delinquent reports had been filed and any delinquent taxes, penalties, and interest had been paid. The comptroller then would have to restore the entities' corporate privileges.

Stockholders, directors, or officers of entities when they underwent forfeiture of privileges or judicial forfeiture could file lawsuits (bills of review) against the attorney general and secretary of state in a Travis County district court to set aside judicial forfeitures. The comptroller would have to restore an entity's privileges if a court set aside the forfeiture. The comptroller and secretary of state would have to note the court's decision in the entity's record.

An entity that requested the setting aside of a forfeiture by the secretary of state would have to determine from the secretary of state whether its corporate name still was available for use. If not, the entity would have to change its name.

SUPPORTERS SAY:

The enforcement authority described in this bill exists in Tax Code, ch. 171, which would be repealed by another section of CSHB 3. This section of the bill would place those enforcement mechanisms in the Tax Code's general provisions so that the comptroller and secretary of state would not lose valuable tools to obtain compliance with all the state's tax laws following the expected repeal of the franchise tax. No new or broader powers, however, would be given to either the comptroller or the secretary of state to enforce tax laws.

This bill also would subject the state's 100,000-plus limited partnerships to these enforcement mechanisms as non-corporate entities. General partnerships and sole proprietorships would not be subject to the provisions of this bill because they do not enjoy liability protection, nor do they register with the state in order to do business here. The comptroller still would have other enforcement measures available against them, however, including placement of liens, seizure of assets, and closing down operations.

Under current law, once corporations forfeit their privileges they essentially function like partnerships. At that point, the comptroller may enforce payment of taxes other than the franchise tax, which partnerships do not have to pay. Making partnerships subject to the new enforcement regime would only be fair to other companies.

OPPONENTS SAY: General partners of limited partnerships do not enjoy the same level of privileges, including limited liability protection, as do limited partners or most other registered business entities in Texas. Therefore, they should not be subject to the same strict enforcement methods as are their corporate counterparts.

SALES TAXES

BACKGROUND: Under Tax Code, secs. 151.051 and 151.101, the state imposes a 6.25 percent sales and use tax on the price of taxable items sold in Texas or bought elsewhere for consumption in Texas. The tax rate has been raised seven times since first adopted in 1961, most recently from 6 percent in 1990. Aggregate local rates are capped at 2 percent, meaning that combined state and local rates may not exceed 8.25 percent in any locality. Cities and transit authorities may levy between 0.25 percent and 1 percent. Counties and other special purpose districts may levy between 0.5 percent and 1 percent. Since 1997, hospital districts may levy sales taxes in increments of 0.125 of 1 percent.

Many communities and most major urban areas have reached the 8.25 percent overall cap, but the statewide average combined (state/local) rate is 7.9 percent, according to the Sales Tax Clearinghouse. It reports that the national average combined rate is 6.25 percent. Texas currently has the ninth highest average combined rate. The top eight in descending order are Tennessee, 9.4 percent; Louisiana, 8.55 percent; New York, 8.45 percent; Washington, 8.35 percent; Oklahoma, 8.1 percent; and Alabama, Arkansas, and California, 7.95 percent. Delaware, Montana, New Hampshire, and Oregon levy no sales tax at any governmental level. Alaska has no state sales tax, but its local rates average 1.05 percent. At 6.25 percent, Texas is tied with Illinois for the third highest state sales tax rate, according to the Federation of Tax Administrators. Mississippi, Rhode Island, and Tennessee top the nation at 7 percent, followed by Minnesota, Nevada, and Washington at 6.5 percent.

The sales tax is an excise tax on consumption that has two facets. The major component is the sales tax levied on transactions involving taxable items (goods and services) that occur between parties within the state. Its counterpart, the use tax, applies to the use within the state of taxable items that change hands between parties that both are located outside the state. The use tax can affect either buyers or sellers. Out-of-state vendors who have established a connection substantial enough to determine taxability (nexus) with Texas must collect and remit use taxes from their Texas customers. Texans buying taxable items from out-of-state companies without nexus must pay use taxes to Texas.

The sales tax applies to all retail sales and leases, most rentals, and some services. Sales of some products and commodities are taxed separately. These include insurance premiums, mixed drinks, motor fuels, motor vehicles, and boats and boat motors.

The state imposes several taxes on motor vehicles, including a 6.25 percent retail sales and use tax (secs. 152.021(b), 152.022(b)) on vehicles bought within Texas and bought elsewhere and used in Texas; a 6.25 percent use tax on tax-exempt vehicles returned for use in Texas that originally were bought here for use outside the state (sec. 152.028(b)); and a two-tiered gross receipts tax on motor vehicle rentals of 10 percent for the first 30 days (or less) and 6.25 percent for more than 30 days (sec. 152.026(b)).

The state also imposes a 6.25 percent retail sales tax on taxable boats and boat motors bought in Texas (sec. 160.021(b)) and a 6.25 percent use tax on retail sales of taxable boats and boat motors bought elsewhere and used in Texas (sec. 160.022(b)). These items are not subject to local sales and use taxes.

Major exemptions to the sales tax include manufacturing materials, machinery and equipment; food for home consumption; residential gas and electricity; agricultural feed, seed, chemicals, and supplies; prescription medicine; over-the-counter drugs; and data processing and information services. Major exclusions include medical, legal, architectural, engineering, automotive repair, financial, dental, accounting/auditing, real estate, advertising, and child care services. For fiscal 2005, the Comptroller's Office estimated the value of all exemptions at more than $19.5 billion and all exclusions at more than $4.3 billion. For the current biennium, the projected values are almost $39.9 billion for exemptions and about $8.9 billion for exclusions.

Sales of 17 types of services are taxable under Tax Code, sec. 151.0101(a). Exemptions include water (sec. 151.315); newspaper sales and subscriptions, custom newspaper printing, and inserts (sec. 151.319); magazine subscriptions (sec. 151.320); and the first $25 of basic monthly Internet access charges (sec. 151.325). Mixed drinks are among several exempt items (sec. 151.308) taxed by other law.

In fiscal 2004, state sales tax revenue increased 7.9 percent from the previous year to almost $15.4 billion, which was 24.8 percent of all state revenue and 55.2 percent of state tax revenue. Sales tax revenue is expected to exceed $32 billion in the current biennium. Business purchases comprise roughly half of sales tax revenue in any given year.

Most sales tax collections are remitted by retailers and other businesses, which are compensated for their costs with handling fees called discounts (currently, 0.5 percent of tax due). Almost all sales tax money goes into the general revenue fund, with two exceptions – sales tax revenue on motor oil and other lubricants goes into the state highway fund, and $31 million in sporting goods sales tax revenue benefits parks, recreation, and wildlife programs. One-fourth of motor vehicle sales tax revenue goes into the foundation school fund.

DIGEST: CSHB 3 would raise the state sales and use tax rate from 6.25 percent to 7.25 percent. Billboard advertising services would be taxable, as would water sold in a sealed container. Motor vehicle repair services and vehicle wash and detail services would be taxed as well. The exemption for newspapers sold individually or by subscription would be repealed.

The bill also would impose a 3 percent tax on the retail sale of soft drinks and snack food. This tax would be in addition to any other tax imposed by state law and would not apply to any snack or soft drink sold by a business such as a restaurant for consumption on the premises of that business. The rate at which motor vehicle sales are taxed would be raised from 6.25 percent to 7.35 percent. This rate would apply to vehicle sales made in Texas and on sales made outside the state to a Texas resident. The bill would increase – from 6.25 percent to 7.35 percent – the rate at which a motor vehicle rented for longer than 30 days is taxed. The boat and motor boat sales tax rate also would increase from 6.25 percent to 7.35 percent.

"Billboard advertising service" would include billboard space rental. A billboard would be defined as a separate, fixed sign that is directly attached to land or buildings and designed for frequent and economically feasible content changes and to prominently display outdoor advertising visible to passing motorists.

"Motor vehicle repair services" would be defined as the repair, remodeling, maintenance, or restoration of a motor vehicle and would include testing, diagnostics, painting, body repair, engine repair, transmission repair, exhaust system repair, brake repair, and air conditioning repair. "Motor vehicle wash or detail services" would be defined as the exterior or interior cleaning of a motor vehicle, including washing, waxing, polishing, buffing, detailing, shampooing, vacuuming, finishing, or steam cleaning. Automated and coin-operated, self-service car wash facilities would be included in the definition.

"Snack food" would be defined as any item sold for consumption without requiring further preparation that is not considered a major component of a well balanced meal. This would include baked items such as pastries, donuts, cakes, tortes, pies, tarts, bars, and cookies; candy; chips; popcorn; pretzels; and roasted nuts. "Soft drink" would be defined as any beverage containing sweeteners and would exclude any beverage that included milk or milk products, soy, rice, or similar milk substitutes, or 50 percent or more fruit juice by volume. The definition of soft drink also would exclude infant formula and any item intended for weight reduction. The comptroller by rule would adopt the manner in which the tax would be administered. Revenue generated from this tax would go into the general revenue fund.

The overall sales tax rate increase and the taxation of billboards, vehicle repair services, car wash services, bottled water, and newspapers, would take effect July 1, 2005, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, these provisions would take effect October 1, 2005.

The vehicle and boat sales and use tax increase and the tax on snacks and soft drinks would take effect July 1, 2005, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, these provisions would take effect September 1, 2005.

Services taxed under this bill that were subject to a written contract entered into before June 1, 2005, would be exempt from taxation until July 1, 2007.

SUPPORTERS SAY:

Sales taxes remain one of the most stable and reliable revenue sources, tracking a wide variety of economic activities in the state, both individual and business. The general sales tax rate has not increased in 14 years, and the vehicle sales tax rate has not increased in 13 years. A 1-cent sales tax rate increase still would give Texas a maximum combined rate lower than seven other states, including Louisiana, Arkansas, and Oklahoma. Texas' average combined rate likely would not be significantly higher than those three border states.

One of the virtues of the sales tax is its simplicity. It is calculated based on the purchase price and collected at the point of sale. No year-end statements of individual sales taxes paid are generated, although they are included on almost every invoice or receipt. It is familiar to most taxpayers, who are accustomed to paying it, and to virtually all retailers and businesses.

Sales taxes mostly are discretionary. They derive revenue from purchasing decisions that businesses and individuals could choose not to make. The regressiveness of sales taxes compared to other taxes is exaggerated. It is mitigated in Texas by numerous exemptions or exclusions on what many people consider necessities (e.g., groceries, medicine) or goods and services with great social or economic benefits (e.g., child care, advertising).

None of the bill's newly taxable items could be considered essential, nor would taxing them be inherently punitive. As with many products, consumers can choose from a number of price ranges when buying a vehicle. Most boats are luxuries, and their purchase is generally discretionary. Bottled water sales should be taxed like other bottled beverages. Billboards are one of the most limited forms of advertising, and businesses have other means of marketing available. In addition, taxing snack food and soft drinks would allow the state to discourage consumption of unhealthy products while generating new general revenue that could be used for education and health care services.

The service industry primarily re-circulates wealth, whereas mining (oil and gas) and manufacturing create it. So it is appropriate to continue excluding or exempting most services so as not to inhibit the economic recovery. Raising sales taxes now on services that contribute so heavily to Texas' fragile economy could cost jobs and undermine revenue.

The state is facing a property tax crisis that could be mitigated by this modest sales tax rate increase and base expansion. Any new taxes levied in the bill are necessary to provide meaningful property tax relief to Texas citizens. Texas families and businesses are burdened with some of the highest property tax bills in the nation, and this relatively modest shift in state sales tax policy would generate $3.4 billion by 2007 that could be refunded to taxpayers, benefiting the state and its economy.

The slight increase in the number of items and services taxed would not create significant compliance problems for retailers or consumers. The Streamlined Sales Tax Agreement aimed at providing uniform tax administration to facilitate taxation of interstate sales is progressing toward fruition and has ample flexibility to deal with such minor changes on a state-by-state basis.

The U.S. Congress last year enacted the American Jobs Creation Act of 2004, allowing taxpayers in states like Texas without a federal income tax to deduct state sales taxes from their federal income taxes. This law eliminated discrimination against residents of states that choose to levy sales taxes in place of a tax on income

OPPONENTS SAY:

The sales tax is a diminishing revenue source, a fiscal dinosaur no longer growing at the same pace as the national and Texas economies. Expanding the sales tax rate would swap one tapped-out revenue source, the school property tax, for another. Absent an income tax or other broad-based tax, the sales tax is becoming incapable of sustaining state government as demands grow.

Three trends are contributing to the sales tax's shrinking revenue-generating capacity, according to the National Conference of State Legislatures – the transition to a more service-oriented economy, the proliferation of exemptions, and burgeoning interstate commerce on the Internet. All three of these trends are present in Texas, eroding the sales tax base and reducing revenue. Replacing revenue from the stable, expanding base of property taxes with the diminishing base of sales taxes would not be sound fiscal policy.

Sales taxes are notoriously regressive. They have a greater proportional impact on low- and moderate-income taxpayers than on the affluent, who better can absorb increases in the costs of goods and services caused by higher sales taxes. In the current school finance context, it would be poor public policy to use such hikes to relieve the tax burden on a smaller segment of the overall tax base (i.e., property owners) by shifting more of the tax burden on to the more numerous and already overburdened sales tax payers. Because many are renters, they would benefit the least from property tax relief and ultimately would pay more in total taxes.

Having to pay sales tax at a rate of 7.25 percent, consumers in Texas' still shaky economy would have to absorb a sales tax rate increase of 15 percent. Texas would have the highest state sales tax rate in the nation, and all four states that border Texas would have lower state rates. Texas' average combined rate likely would be near 9 percent, second only to Tennessee and higher than all bordering states.

Raising Texas' already high sales-tax rate to an exorbitant level would put much of the state's business community, especially dealers in durable goods and taxable services, at a competitive disadvantage. The proximity of many Texas consumers to the borders of four lower-tax states and one potentially duty-free international trading partner, coupled with the proliferation of the Internet and the growing popularity of electronic commerce, could harm the state's economy.

It would be unfair to expand the sales tax to some services by targeting a few exemptions and exclusions while sparing most or all exempt items or excluded services. No good rationale exists for singling out billboard advertising and bottled water over other segments of their respective industries, nor for raising taxes on retail vehicle sales or long-term rentals but not on seller-financed sales or short-term rentals. In addition, by taxing automobile repairs, Texas would begin taxing an essential service, the burden of which would fall most heavily on low-income individuals.

For the limited revenue it would generate, taxing newspaper sales would not be worth the substantial implementation difficulties it would create. Most newspapers are distributed through small-scale independent contractors, thousands of whom would be required to file tax reports to the state. Further, collection of a 4-cent sales tax through coin-operated newspaper vending machines would be cumbersome, and machines that do not now accept pennies would have to be re-fitted at substantial cost to the machine owners. It would be inappropriate for the state to single out print media for taxation, while radio and television are not taxed for their product.

An additional 3 percent tax on snacks and soft drinks unfairly would discriminate against a specific industry and Texas consumers. Some items listed in the bill would be taxed at a combined rate of 12.25 percent in much of the state, an excessive rate that would negatively affect grocery and convenience stores across Texas.

The snack tax would complicate Texas' tax code at a time when the state should be simplifying its revenue system. Some of the "snack foods" that would be taxed at 3 percent currently are exempt from state sales taxation and would be taxed at a new rate of 3 percent under CSHB 3. As currently written, the bill would levy the higher tax on someone who bought a Coke "to go" from McDonald's, but if the individual bought a soft drink and consumed it on premises, that person would not be taxed at the higher rate. This distinction would undermine any purpose of discouraging purchase of snack foods.

Sales tax policy in Texas can be confusing. Consumers, and even some retailers, often cannot remember which goods and services are taxed and which are exempt or excluded. Sales tax application needs to be more uniform. Undoing a select few exemptions and exclusions could undermine Texas' participation in the Streamlined Sales Tax Project, which is aimed at harmonizing states' sales tax laws so that Congress will allow states to tax electronic interstate commerce.

Recently enacted legislation authorizing deduction of state sales taxes from the federal income tax is set to expire after the 2005 tax year. It would be unwise to expand the sales tax on the assumption that the federal government will continue this exemption, particularly given the current size of the federal budget deficit.

OTHER OPPONENTS SAY:

The sales tax should be as broad and as low as possible. Before raising the rate, it should be expanded to cover at least household, if not business-to-business, services. Service industries constitute a high-growth sector of the state's economy that is not paying its fair share. In fact, that may be one reason it is growing so fast. It would be unfair to increase the burden on a few consumers but not on those of a huge segment of the economy. Service base expansion would bolster sales tax stability. It also would help offset electronic commerce losses because more goods than services are sold online.

Raising sales taxes to lower property taxes would not be an equitable trade-off. Taxpayers would have to pay more of a regressive tax in order to pay less of a federally deductible tax. Moreover, it would reduce the revenue available to meet state needs. Texas should couple property tax relief with a modest, broad-based income tax that would grow with the economy.

Low-income families receiving government assistance should be exempt from sales taxes through the use of the Lone Star Card or some other secure verification method.

STANDARD PRESUMPTIVE VALUE FOR VEHICLE SALES

DIGEST:

CSHB 3 would require the Texas Department of Transportation (TxDOT) to determine the "standard presumptive value" – or average retail value – of a motor vehicle based on a national industry reporting service. The department would maintain the standard presumptive values of vehicles in its registration and title system and update the data at least quarterly. This data would be made available to county tax assessor-collectors.

A county tax assessor-collector would have to use a vehicle's standard presumptive value to assess the state sales and use tax on the purchase unless the amount paid for the vehicle exceeded its standard presumptive value, in which case the tax would be levied on the higher value. The county tax assessor-collector could assess the sales and use tax on an amount less than the standard presumptive value only if the retail value were shown on a certified appraisal performed by a licensed adjuster and presented by the purchaser to the tax assessor-collector within 20 days after the purchase. In that case, the tax would be levied on the retail value.

On request, a motor vehicle dealer would have to provide a vehicle's certified appraised value to a county tax assessor-collector. The comptroller by rule would mandate the length of time the appraisal information would be held by the county tax assessor-collector and authorize a fee that a dealer could charge for providing the appraisal.

These requirements would not apply to transactions involving an even exchange of vehicles or to a gift.

This provision would take effect July 1, 2005, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2005.

SUPPORTERS SAY:

CSHB 3 would give state and local authorities the tools to collect vehicle sales taxes that already should be paid. Currently, no mechanism exists to ensure that people who transfer titles on used vehicles accurately state the sales price. The state maintains a sophisticated computer network through the registration and title system (RTS) that tracks millions of vehicle titles. It would be technologically feasible to add objective information about vehicle values to the system. TxDOT officials report that changing the RTS system to include vehicle price information would have no significant effect on the agency's budget or on operation of the RTS system. This bill would allow the state to gain significant additional revenue from improved collection of the sales tax on automobiles.

Tax assessor-collectors overstate the difficulty in administering the used car tax collection program. Compliance would increase over time. Most tax assessor-collectors are elected to office understanding that collecting fees and sales taxes on automobile sales will make up the bulk of their responsibilities. They have a responsibility to ensure compliance with all state and local laws, as do all elected officials.

CSHB 3 would provide safeguards to ensure that a consumer would pay taxes on a vehicle's actual price when that price was less than a vehicle's standard presumptive value. A buyer could provide the assessor-collector with a certified appraisal of the vehicle's value to verify that a lower price was paid. Concerns that that individuals who pay a discounted price for damaged vehicles might be inappropriately taxed at an inflated rate value are immaterial.

OPPONENTS SAY:

The bill would put tax assessor-collectors in the position of policing a tax collection program for which they might not be qualified. Determining the value of a particular automobile is a subjective process, even if a clerk has access to RTS values. The new owner could claim that a value is not correct because the vehicle is not in running condition or is damaged. Options or added features such as leather seats or special wheel covers could increase the value of a vehicle.

This change would create greater inconvenience for sellers and buyers. Some vehicles, especially older vehicles or special imports, might not be included in the updated RTS system. A clerk would have to spend 15 minutes or more to research values not included in the system before processing the transfer application. Tax-assessor offices typically are the busiest during the first five and last five days of a month, and the delays caused by this bill could push lines out the doors. Even medium-sized counties such as Brazoria may receive 100 transfer requests for both new and used vehicles from the same automobile dealers, and larger jurisdictions such as Harris County process thousand of transactions on a daily basis. Tax assessor-collectors would not be able to process transfers on a timely basis.

OTHER OPPONENTS SAY:

The requirement that a vehicle buyer obtain a certified appraisal for a purchase would be overly onerous. The bill should be amended to allow an individual to present a receipt prepared by the seller that shows the price paid for the vehicle.

TOBACCO TAXES

BACKGROUND:

Texas levies three separate tobacco taxes — one on cigarettes, another on cigars, and a third on other tobacco products (OTP), including chewing/smoking tobacco and snuff. The cigarette tax rate is 41 cents per 20-count pack — $20.50 per thousand for cigarettes weighing three pounds or less per thousand, plus an extra $2.10 per thousand for those weighing three pounds or more per thousand. Cigars that weigh three pounds or less per thousand are taxed at 1 cent per 10, while cigars that weigh three pounds or more per thousand are taxed at $7.50, $11, or $15 per thousand, depending on retail price and tobacco content. The OTP tax is 35.21 percent of factory price.

Major exemptions include importation of small quantities (up to 200 cigarettes for personal use and small numbers of inexpensive cigars) as well as Indian tribal and federal sales. Wholesale distributors must remit all three taxes. Cigars, cigarettes, and OTP also are subject to sales taxes — a 6.25 percent state tax and up to 2 percent local tax – and to federal excise taxes of 39 cents per pack on cigarettes and various rates, mostly by weight or quantity, for cigars and other tobacco products.

In fiscal 2005, the comptroller estimates that the state will collect $558.8 million in revenue from total tobacco taxes. Of this amount, the cigarette tax is expected to generate $496 million. After an 8-percent decrease in tobacco tax revenue from fiscal 2003 to fiscal 2004, tobacco taxes are expected to increase 4.5 percent from fiscal 2004 to fiscal 2005, according to the Comptroller's Office. These taxes are expected to generate $1.1 billion during fiscal 2004-05 and $1 billion in fiscal 2006-07. After allocation of any administrative cost appropriations, 18.75 percent of the first 10 cents' worth of cigarette tax revenues on 20-count packs (and the first 20.5 cents' worth on larger packs) is allocated to the foundation school fund, with the remainder going into the general revenue fund.

Texas increased its cigarette tax rate for the ninth time in 1990 and also has raised cigar and OTP rates several times. As of January 1, 2005, Texas' cigarette tax rate ranked 40th among the 50 states and the District of Columbia. Rhode Island had the highest rate per pack at $2.46, while Kentucky's 3-cent rate was the lowest. Rates per pack in states bordering Texas were 91 cents in New Mexico, $1.03 in Oklahoma, 59 cents in Arkansas (plus a dealer enforcement/administration fee), and 36 cents in Louisiana. The U.S. median rate was 69.5 cents.

DIGEST: CSHB 3 would increase all tobacco tax rates. The cigarette tax rate would increase by $1 to $1.41 per pack. The lowest cigar tax rate would rise from 1 cent to 3.44 cents per 10 or less. Rates per thousand for the three categories of larger cigars would rise from $7.50 to $25.80, from $11 to $37.84, and from $15 to $51.60. The OTP tax rate would rise from 35.21 percent to 40 percent of the manufacturer's list price. This provision would take effect July 1, 2005, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2005.

SUPPORTERS SAY:

Increasing taxes on cigarettes and other tobacco products would provide government with a reliable revenue stream while reducing tobacco use, saving lives, and lowering health-care costs.

Tobacco taxes provide a reliable source of revenue that remains relatively unaffected by rate increases. Cigarette tax revenue in Texas has been declining on average only by about 0.7 percent a year since 1993, despite price hikes and base erosion at more than double that rate. Since 2002, more than 30 states have increased their tobacco tax rates, generating significant new revenue in each instance. When Alaska raised its cigarette tax by 71 cents per pack in 1997, revenue initially doubled and has remained steady at a much higher level over a five-year period. Revenue declines due to higher rates are gradual, predictable, and easily compensated for with small incremental rate hikes. The tax increase would raise about $800 million in additional annual revenue, an estimate that accounts for existing declining usage trends, reduced consumption attributable to the rate increase, and tax avoidance behavior.

While tobacco is an addictive product that many customers will continue buying regardless of price hikes, tobacco taxes still are a self-assessing user fee on discretionary consumption. No one is forced to start smoking, and ample resources are available to smokers who wish to quit for health or economic reasons. Avoiding the tax is a matter of individual choice.

Taxing an activity does not mean condoning it. To the contrary, it often discourages inappropriate behavior or harmful activities. The state does not tax sales to penalize commerce, nor does it fine bad drivers to promote traffic violations. Because a certain segment of the population will use tobacco regardless of cost, the state is perfectly justified in taxing that activity and funding education with the proceeds.

Higher tobacco taxes would help the state recoup some of its tobacco-related health-care costs by discouraging smoking among Texans, particularly among price-sensitive young people. For example, the American Cancer Society estimates that Texas eventually could save up to $1 billion a year in Medicaid expenses and up to $10 billion overall by raising the rate $1 per pack. Tobacco tax revenue need not be dedicated to health-care programs because under the Texas tobacco settlement the tobacco industry already provides funding for this purpose.

Tax avoidance caused by higher tobacco prices in Texas would be nominal, short-lived, and too small to offset the economic benefits of the rate increases. The opportunity for consumers to buy cheaper cigarettes is limited to small segments of the population living across the border from neighboring states and Mexico. It is unlikely that this activity would have any meaningful impact on tobacco-tax revenue collected in Texas.

OPPONENTS SAY:

Raising tobacco taxes to enhance revenue is not sound fiscal policy. Tobacco use, particularly smoking, already is declining, which has led to an average annual revenue decrease of 2 percent (inclusive of population growth), according to the Comptroller's Office. The comptroller projects a 20 percent drop in consumption in the first year after a rate hike of $1 per pack, followed by a 4 percent average annual revenue decline. This estimate is based on a phenomenon called "steepening avoidance," taking into account bootlegging and black-market sales, in which higher costs gradually reduce discretionary consumption. Funding for crucial governmental functions should not be dependent on a shrinking revenue source.

Estimates of new revenue that would be generated by a $1 rate hike are inflated because the ratio used to correlate price and sales does not account for some recent factors that affect taxable consumption of cigarettes, including price hikes and Internet sales. As a result, Texas likely would collect much less per year than has been estimated. By way of comparison, in the six years since New York increased its cigarette tax by 98 cents, sales volume has dropped 41 percent.

Raising tobacco taxes to help pay for property tax reduction or general state services amounts to "tax profiling." It forces a narrow class of taxpayers to subsidize a public good to a greater degree than other taxpayers. Smokers already are taxed at the state and federal levels and through the tobacco settlement. In addition, cigarette taxes are regressive because they charge all smokers the same rate, regardless of ability to pay. A tax increase would disadvantage lower-income smokers, particularly young smokers, to a greater degree than higher-income smokers.

The state should not use objectionable and self-destructive behavior to pay for beneficial state services. To do so would be hypocritical and could send a message to Texas children that smoking is somehow to be encouraged.

A $1-per-pack rate hike on cigarettes would be a 244 percent increase that would put Texas at a competitive disadvantage with regard to its neighboring states, all four of which would have substantially lower rates. It would increase black-market trade and encourage out-of-state shopping, especially on Indian reservations, in duty-free shops in Mexico, and over the Internet. State tax officials in Washington state report difficulty dealing with avoidance tactics resulting from its latest cigarette tax hike, a problem that Texas would experience even more acutely.

It would be unfair to raise cigar tax rates 244 percent and the OTP rate 13.6 percent when these products do not have near the market share or health effects of cigarettes.

OTHER OPPONENTS SAY:

The principle of tax fairness dictates that any additional tobacco tax revenue should be dedicated to health care or anti-smoking programs, not to general revenue or education. A tax increase of $1 per pack of cigarettes, for example, could generate enough revenue to restore funding cut from the Children's Health Insurance Program and Medicaid during the 2003 regular session.

Some mechanism should be included to reduce the adverse immediate impact of a massive cigarette tax hike on wholesalers. Because wholesalers must buy tax stamps in advance, their floor stocks would be subject to an immediate price hike when the higher tax rate took effect. A grace period for supplemental tax payments longer than the current 30 days or a delayed payment option would soften the blow. At the same time, the bill also should contain strict enforcement measures to ensure that wholesalers and distributors do not stockpile tobacco products before the tax hike takes effect, then sell them at lower prices, as has happened in some other states that raised taxes.

TAXATION OF NON-PARTICIPATING TOBACCO COMPANIES

BACKGROUND:

In 1996, Texas filed a federal lawsuit accusing the tobacco industry of violating conspiracy, racketeering, consumer protection, and other provisions of state and federal law. The state sought to recover billions of tax dollars it had spent to treat tobacco-related illnesses. In settling the lawsuit, the industry agreed to pay the state $15 billion over 25 years and to pay about $2.3 billion through fiscal 2003 to Texas counties and hospital districts that had intervened in the settlement. Florida, Minnesota, and Mississippi also reached separate settlements, while 46 other states joined the Master Settlement Agreement (MSA).

The total value of all settlements between states and the tobacco industry is $246 billion, the largest of its kind. Actual payments by the industry are subject to adjustment formulas related to tobacco sales, inflation, and industry profitability. Under Texas' settlement terms, payments from the industry rise or fall in proportion to U.S. consumption of cigarettes each year as compared to consumption in 1997.

Five tobacco companies were party to the MSA: Brown & Williamson Tobacco Corporation; Philip Morris Inc.; Lorillard Tobacco Company; R.J. Reynolds Tobacco Company; and Liggett Group. The MSA permits other manufacturers, called non-participating manufacturers (NPMs), to join the settlement and make annual payments to states, which some have done. The MSA also encourages all participating states to draft a "qualifying statute" to equalize the cost advantages an NPM otherwise might enjoy. Many states did this by establishing an escrow account, which NPMs paid into and against which the cost of any future litigation would be charged.

DIGEST: CSHB 3 would impose a tax of 2 cents on each cigarette (40 cents per pack) and each .09 ounce of tobacco product made, imported, or distributed by an NPM. On January 1 of each year, the comptroller would increase the tax by 3 percent or the most recent annual percentage increase of the Consumer Price Index for all Urban Consumers. All NPMs would be required to pay the tax if their products were sold, distributed, or purchased in Texas.

Distributors that carry tobacco products would be required to amend their monthly required business activity report to the comptroller and add information about their business with NPMs. Based on this information, the comptroller would compute the tax owed and mail a notice to each manufacturer within 10 days of receiving the distributor's report. The tax would be due by the 15th day of the month following the month in which the comptroller sent the notice. Each manufacturer owing the tax also would be required to certify compliance with the reporting and tax requirements to the attorney general. The attorney general would compile a list of manufacturers in compliance, publish it on the attorney general's website, and make it available upon request.

An NPM that intended to offer cigarette products for sale or distribution that previously had not been sold or distributed in Texas would be required to prepay one month's estimated tax. The tax would be equal to the greater of $50,000 or a percentage of projected sales computed by the comptroller. The comptroller would settle up with the manufacturer after the first month and then the regular tax deadlines would apply. Before offering any products for sale, an NPM also would be required to report business information to the attorney general and state an intention to comply with reporting and taxing requirements.

Failure to comply with reporting or payment of taxes would be penalized in the same way as noncompliance with existing tobacco tax requirements. The comptroller would send notices of noncompliance and, upon receipt, the NPM would be barred from paying the tobacco taxes, affixing any tax stamp to a package of cigarettes, or otherwise purchasing, selling, or distributing cigarettes in Texas.

This provision would take effect July 1, 2005, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2005.

SUPPORTERS SAY:

CSHB 3 would create an equitable situation for all tobacco manufacturers. In the current environment, the five large manufacturers that settled with Texas pay about 40 cents per pack of cigarettes toward the tobacco settlement fund while other companies pay nothing. NPMs have come to market since the settlement and take advantage of their more favorable regulatory structure to price their products well below those of the competition. The companies that participated in the settlement are paying the state for possible health costs related to smoking, yet only a few of the companies that manufacture cigarettes pay into it. NPMs should pay because their products are as culpable as any other manufacturer's.

Taxing NPMs could generate a reliable source of revenue for Texas. Some industry experts estimate that a 40-cent tax per pack of NPM cigarettes would generate about $25 million per year.

This bill would not unduly harm NPM's business. Under the MSA, NPMs already are paying into an escrow account in other states. The cost of those payments is built into their pricing and has not put them out of business.

A similar provision in Minnesota was upheld by the Minnesota Court of Appeals for the 4th Circuit in August 2004, (*Council of Independent Tobacco Manufacturers of America, et al. v. State of Minnesota* 685N.W.2d 467). Four years after Minnesota settled with tobacco manufacturers outside the MSA, the state found that the market share of major manufacturers had fallen from 98 percent to 88 percent as NPMs captured greater market share. In 2003, Minnesota imposed a tax of 1.75 cents per cigarette (or 35 cents per pack) on NPMs. The tax was challenged on equal protection, uniformity clause, bill of attainder, special legislation, and free speech grounds, but was upheld.

This bill would protect the tobacco settlement funding stream. Because tobacco settlement funds depend on sales of cigarettes, the more market share manufacturers outside the agreement garner, the fewer funds will flow into the state's tobacco settlement coffers. Those funds support important programs in Texas, including the Children's Health Insurance Program. Manufacturers that do not participate should not be able to undermine the state's commitment to health care for children in low-income families.

This provision would support the state's efforts to curb smoking. Some manufacturers, because they are not making payments toward the settlement with Texas, can sell their products for less than other manufacturers. Low-cost cigarettes encourage smoking, particularly among teens and young adults, which thwarts the state's public policy goal of reducing underage smoking.

OPPONENTS SAY:

This provision unfairly would tax one group of manufacturers –– the NPMs. The only reason they have lower costs than the big manufacturers is because they had not been sued by states and did not sign an agreement promising to pay a settlement. Taxing them to make up for the difference would be akin to having taxed all car manufacturers for the costs incurred by Ford in the 1970s due to manufacturing defects in its Pinto model. NPMs should not have to pay a new tax because their brands were not the subject of lawsuits.

CSHB 3 would impose the cost of a tobacco suit without the benefit of protection from future litigation. The big manufacturers settled with states to halt future litigation and, in return, promised to pay according to the terms of the settlement. This tax on NPMs would charge them for the cost of the tobacco settlement, but they still could be sued by the state at any time.

NPMs are not as culpable as the manufacturers that settled. Those manufacturers hid information about the health effects of smoking, while NPMs, which tend to be younger companies, have carried surgeon general's warnings and adhered to advertising and marketing restrictions. The basis for the initial lawsuits was not the health effects of smoking per se, but that big manufacturers failed to disclose information about the dangers associated with smoking. NPMs should not be punished for other companies' wrongdoing.

This bill would be different from the law enacted in Minnesota and could be vulnerable on antitrust, equal protection, and interstate commerce grounds. Because the provision in this bill would restrain trade by one group and would purport to protect the financial interests of the tobacco settlement, the law could be open to charges of an antitrust violation, while the establishment of two classes could be the basis of an equal protection lawsuit. Because this bill would tax manufacturers, which can be located anywhere in the world and may not even have offices in Texas, it also could violate interstate commerce protections. Minnesota's experience might not serve as a good example of how this bill would fare if enacted in Texas. Although its law has been upheld by lower courts, the Minnesota Supreme Court has accepted the case for review.

This provision would double-tax some manufacturers. Companies that joined the MSA after the initial signing pay settlement funds based on their national sales, including sales in Texas, although Texas does not receive any portion of that payment because Texas is not an MSA state. If Texas imposed an additional tax on those companies, it effectively would double-tax them.

The market share garnered by NPMs is not very significant and may be declining. According to some estimates, the market share held by NPMs in Texas is less than 10 percent. Because of aggressive marketing techniques by the large manufacturers, NPMs have not made significant inroads and their market share may be declining in spite of their ability to offer cheaper tobacco products.

This provision might not generate nearly the rosy revenue picture promoted by some. Based on consumption and market share trends, the fiscal estimate is in the range of $6 million to $8 million per year. As a source of revenue, this would not be particularly reliable as it depends on continuing sales of NPM cigarettes. If it is true that NPMs' products are competitive on price alone, then removing the price differential should cause their sales to drop significantly.

Although most Texans support efforts to curb underage smoking, the state does relatively little in this regard. Most of the public education campaigns today are financed by private donations or the tobacco industry through its settlement agreement. Texas spends relatively little on smoking cessation campaigns, and most of the money the state collects through the tobacco settlement agreement is used to fund health programs other than smoking cessation.

OTHER OPPONENTS SAY:

Establishing an escrow arrangement for Texas would be much more equitable than imposing a special tax on NPMs. Under the MSA, many states addressed the price differential by requiring NPMs to either join the settlement or pay into an escrow account that would be used in the event of future litigation. Instead of paying a new tax without protection from future litigation, an escrow arrangement would equalize the costs borne by all manufacturers and offer protection from litigation to NPMs in return.

All tobacco companies should pay for the industry's historical wrongdoing, and that money should go toward health care for needy Texans. Any additional revenue generated by the provision should be dedicated to the Children's Health Insurance Program with a hold harmless provision that would prevent budget writers from swapping new revenue to free up general revenue for other purposes, such as property tax relief.

A better way to structure this tax would be to apply it to all distributors, as with the current cigarette taxes, and exempt sales of products made by the settling defendants in Texas. This appropriately would not create two classes of manufacturers, would apply to business activities conducted in Texas, would be handled in an established manner by the comptroller, and would tie the tax to shipped and received cigarettes, not those bound for other states.

TELECOMMUNICATIONS INFRASTRUCTURE FUND

BACKGROUND: The 74th Legislature in 1995 enacted HB 2128, creating the Telecommunications Infrastructure Fund (TIF) to finance access to telecommunications services for public schools, nonprofit hospitals, public libraries, and higher education institutions across the state. The fund was created and maintained through an assessment of 1.25 percent of the telecommunications providers' taxable receipts and was authorized to collect up to $1.5 billion over 10 years. TIF was governed by a nine-member board, which awarded grants for Internet connections, computer hardware, distance learning, telemedicine technology, and technology training programs to eligible entities.

Citing the state's budget shortfall, Gov. Perry in January 2003 froze $224 million of the TIF board's fiscal 2003 appropriation. The 78th Legislature later eliminated the TIF board's appropriation and directed money from the fund toward other programs, including a pre-existing "technology allotment" of $30 per student that had been funded through general revenue. The Legislature did not appropriate any money for new grant awards for the fiscal 2004-05 biennium and instead appropriated $2.1 million to the board to oversee existing grants before the board's 2005 Sunset review. Gov. Perry vetoed this appropriation and transferred all of the TIF board's remaining funds, assets, and employees to the Texas Workforce Commission, which is responsible for closing out all outstanding grants.

In addition to eliminating TIF grants, the 78th Legislature increased TIF's revenue cap from $1.5 billion to $1.75 billion, allowing the fund to continue collecting receipts from telecommunications providers. The Legislative Budget Board projects that TIF will reach its $1.75 billion cap in fiscal 2005.

DIGEST: CSHB 3 would repeal the current $1.75 billion TIF cap. The bill also would extend the expiration date of the fund until September 1, 2011. Revenue collected under this TIF assessment would go into the general revenue fund.

After the amount paid into the fund by all utilities equaled $1.5 billion, a telecommunications utility could recover the amount that it paid into the fund from its customers through their monthly bills. A utility could collect from its customers only the amount assessed after the fund had reached

$1.5 billion. The comptroller would publish in the Texas Register the date on which the fund equaled this amount. A utility that wished to recover its assessment would have to file an affidavit no later than February 15 of each year stating the amount it paid to the fund and the amount it collected from its customers during the previous year.

This article would take effect July 1, 2005, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2005.

SUPPORTERS SAY:

Eliminating the revenue cap for TIF would result in $200 million per year to be used for property tax relief and essential government services. TIF was restructured during the regular session of the 78th Legislature, and funds from TIF have been used for the $30-per-student technology allotment, fulfilling the fund's original goal of promoting technology in schools. Eliminating the revenue cap and extending TIF's existence would continue to enrich the educational opportunities of Texas schoolchildren.

Given that the telecommunications utilities have met their obligations up to the original revenue cap of $1.5 billion, it would be reasonable to allow those incumbent local exchange carriers (ILECs) that have not been passing the 1.25 percent assessment on to consumers to now do so. During negotiations in 1995 when the Legislature was considering creation of TIF, the ILECs agreed to absorb the assessments on their receipts without passing those charges on to customers. The ILECs have fulfilled this obligation every year since TIF was created. After TIF exceeds its original cap of $1.5 billion, it is only fair that ILECs be statutorily authorized to pass additional TIF charges on to their customers, as the competitive carriers have been doing since 1995.

OPPONENTS SAY:

Allowing ILECs to pass their 1.25 percent assessment on to customers would amount to a new tax that millions of consumers would have to pay each month. Telecommunications companies benefitted greatly from the 1995 Public Utilities Regulatory Act, and in return ILECs pledged to assume the cost of the 1.25 percent TIF assessment. It would be unfair to shift this charge to telephone customers. Texas consumers already shoulder one of the highest rates of taxation for telecommunications services in the nation, and the pass-through provision only would increase this burden.

Eliminating the revenue cap on TIF and using these additional receipts for programs other than technology grants would violate the spirit of the original TIF agreement and amount to a discriminatory sales tax on telecommunications services. Changes in the administration of the fund have shifted contributions into the fund toward general obligations that should not be funded through specific charges on telecommunications utilities and consumers. The state has fulfilled the goal of the original legislation by disbursing more than $1 billion for technology grants since 1995, and TIF now should be retired.