SUBJECT: State revenue revisions and school property tax reduction

COMMITTEE: Ways and Means — committee substitute recommended

VOTE: 5 ayes — J. Keffer, Grusendorf, Paxton, Smithee, Woolley

4 nays — Villarreal, Edwards, Luna, Ritter

WITNESSES: *(On original version:)*
For — Bill Allaway, Texas Taxpayers and Research Association; Clive Bode, BBT Fund, SRI Fund, TPG Partners, and HBK Partners; Robert Miller, Texas REIT Act Coalition; Glen Rosenbaum, Law Firm Legislative Coalition

Against — Jim Allison, Administaff, Inc.; John Garvin, Texas Affiliation of Affordable Housing Providers; Galt Grayden, National Association of Professional Employer Organizations; Dwight Harris, Texas Federation of Teachers; Dick Lavine, Center for Public Policy Priorities; Joe Ratcliff, Texas Grocery and Convenience Association; Karen Reagan, Texas Federation of Drug Stores; Wanda Ruhm, Kurt Summers NFIB; Wayne Zakrzewski, Texas Retailer's Association and JC Penney; David Pedregon

On — George Allen, Texas Apartment Association; Rich Ellmer, Texas MiniStorage Association; Jim Martin, Texas Pharmacy Association; Cyrus Reed, Texas Center for Policy Studies; Jim Sewell, Association of General Contractors; William Hamner, John Heleman, Comptroller's Office; Wayne Pulver, Legislative Budget Board; Mike Morrissey, Brian Newby, Sander Shapiro, and Terri Wagner, Governor's Office;
Stuart Greenfield

SUMMARY

DIGEST: This analysis of CSHB 3 is divided into eight major issue areas: property tax rate reduction (p. 5), ongoing property tax rate buy-down (p. 8), tangible personal property rendition verification (p. 12), franchise tax (p. 14), sales and use taxes (p. 19), standard presumptive value (p. 26), tobacco taxes (p. 28), and collection of delinquent state debt (p. 32). Within these areas, the following topics are covered, described briefly below and in more detail on the pages indicated:

Property tax rate reduction. CSHB 3 would set the maximum ad valorem tax rate for school districts at $1.23 per $100 of taxable property in the 2005 tax year and $1.12 beginning with the 2006-07 school year. It also would permit an additional tax of up to 15 cents for enrichment, if authorized by an election. The rate for the 2005 tax year would be contingent upon HB 2 and HB 3 receiving a two-thirds vote in each house ***(see p. 5).***

Ongoing property tax rate buy-down. The bill would dedicate 15 percent of any surplus in available state revenue each biennium to reducing school tax rates ultimately to a floor of 75 cents per $100 of taxable value. It also would apply any funds in excess of the anticipated amount raised by CSHB 3 to reducing the tax rate for school districts ***(see p. 8).***

Rendition verification. A chief appraiser or authorized agent of the appraiser would be able to request that a property owner provide forms filed by the property owner with the Internal Revenue Service (IRS) relating to the cost and acquisition of fixed assets, including inventory. An appraisal district would be able to contract with an authorized representative to perform rendition verification services. Compensation to an authorized representative could be up to 20 percent of the value of any tax on underreported assets verified by the agent ***(see p. 12).***

Franchise tax. The franchise tax would be applied to out-of-state corporations holding an interest in a partnership doing business in Texas. A partner in an upper-tier partnership would be considered a partner in each lower-tier partnership of the organization for the purposes of the franchise tax. Taxable earned surplus under the tax would include a corporation's share of the gross receipts of each partnership or joint venture in which the corporation directly or indirectly owned an interest ***(see p. 14).***

Sales tax. The state sales and use tax rate would increase from 6.25 percent to 7.25 percent, and the rate on motor vehicle and boat sales would increase from 6.25 percent to 7.35 percent. The tax base would be broadened to include bottled water, computer programs, and motor vehicle repairs. The timely filer deduction would be repealed ***(see p. 19).***

Standard presumptive value. A system would be established to use the standard presumptive value of a vehicle to assess the state sales and use tax on the purchase of a vehicle ***(see p. 26).***

Tobacco taxes. The bill would raise taxes on all tobacco products, including an increase of the cigarette tax from 41 cents to $1.41 per pack ***(see p. 28).***

Collection of state delinquent obligations. Third-party collection of delinquent state debt could be contracted by the attorney general under certain conditions ***(see p. 32).***

Effective date. Unless otherwise noted, the bill would take effect September 1, 2005 if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect November 1, 2005**.**

According to the Legislative Budget Board (LBB), in fiscal 2006-07, the provisions in the bill would generate the following general revenue-related amounts:

($ millions)	Sept. 1 effective date	Nov. 1 effective date
Sales tax rate increase	$4,200	$3,651
Sales tax base expansion	817	751
Motor vehicle sales tax increase and standard presumptive value	937	869
Sales tax increase on boats	15	14
Cigarette and Tobacco taxes	1,396	1,302
Franchise tax	864	864
Collection of delinquent state obligations	17	15
Total general revenue	**8,246**	**7,466**

SUPPORTERS SAY:

CSHB 3 would provide meaningful property tax relief to Texas citizens while ensuring that more Texans paid 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 revenue increases in the bill would be offset entirely by a reduction in the maximum school district maintenance and operations ad valorem tax rate from $1.50 to $1.12. 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 $4.3 billion property tax reduction to taxpayers by 2007 and also would generate 65,000 new jobs and $4.3 billion in additional personal income for the state by 2015.

The bill would mark a shift toward emphasizing consumption taxes on consumer purchases. Consumption taxes are optional, especially with the continued exemption for food and medicine, and fairer than inescapable property taxes. The bill also would close loopholes in the franchise tax, the state's system of business taxation. While the franchise tax is a proven and efficient revenue source for the state, many large businesses have exploited alternative forms of organization to avoid taxation. It is unfair that these businesses avoid the franchise tax, particularly when they receive the benefit of state services. In addition, with higher taxes on tobacco, CSHB 3 would discourage smoking, leading to healthier citizens and lower long-term medical costs.

OPPONENTS SAY:

CSHB 3 is an unfair bill that would benefit only the state's wealthiest citizens while hiking taxes for the vast majority of Texans without generating any net increase in revenues to fund the state's many unmet needs. The LBB reports that, on average, every income group earning less than $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 families with incomes greater than $100,000 would benefit from the bill, with the wealthiest 10 percent benefiting by far the most.

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. The bill would fail to truly modernize Texas' system of business taxation by continuing the state's reliance upon the outmoded franchise tax. The franchise tax still largely would fail to capture the quickly expanding service and information sectors of the economy, and additional loopholes could emerge in the future. While rising property taxes are a serious concern, the solutions provided in this bill would be worse than the status quo.

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 operations (M&O) of public schools. By special law, certain districts in Harris County may tax above this cap.

DIGEST: CSHB 3 would set the maximum ad valorem M&O tax rate for school districts at $1.12 per $100 of taxable property beginning with the 2006-07 school year. It also would permit school districts to levy an additional tax of up to 15 cents for enrichment, if authorized by an election. The reduction in the maximum ad valorem tax rate would apply to districts with a current rate at or above $1.12 and would apply beginning with the 2005-06 school year.

For tax year 2005, CSHB 3 would set the maximum rate of $1.23 plus a possible $0.15 in voter-approved enrichment, if both HB 2 and HB 3 are approved by at least a two-thirds vote of each house. A district would not be required to hold a separate election for the new M&O tax rate if its M&O rate already had been authorized at or above the new maximum rate.

SUPPORTERS SAY: A reduction in the school property tax rate to $1.12 would provide meaningful relief to all Texans. Homeowners would enjoy reduced property tax bills, and the market would ensure that renters benefited through lower rents from savings received by apartment property owners. Consumers would see lower prices for goods and services made possible as businesses realized 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 offset 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 their homes because they no longer can afford to pay the taxes owed on them.

Partially replacing property taxes with taxes paid by additional businesses would not hurt the Texas economy Businesses shouldered approximately 42 percent of the local property tax burden in 2003, and 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 new taxes on some of the state's most prominent business that could be a "job killer" if those businesses decided to leave the state. 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 a 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 continue to profit in the face of 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:

If the Legislature wants to provide meaningful property tax relief to most families, 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 rate reduction. A 38-cent-per-$100 reduction would provide much more relief to the owner of a $600,000 home than to the owner of a $60,000 home, making the tax system even more regressive.

The Legislature should ensure that property tax relief is distributed to all taxpayers, including renters who pay taxes through their rent. A "circuit-breaker" system would accomplish this by returning a renter's portion of a tax reduction through a refund plan. The Legislature would decide how much of a taxpayer's income may be fairly spent on property taxes, based on the amount of rent, and issue a refund for those who are paying more than that percentage. This would make a property tax reduction less regressive as it would offer meaningful tax relief to the estimated 40 percent of Texans who pay taxes as a portion of their rent. Landlords should not receive a windfall tax break without ensuring that at least part of the benefit is passed on to renters.

ONGOING PROPERTY TAX RATE BUY-DOWN

BACKGROUND: Texas Constitution, Art. 3, sec. 49a(a) 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 biennial revenue estimate (BRE) for the succeeding fiscal biennium exceeded estimated revenue in the BRE for the current fiscal biennium. The comptroller would calculate the BRE taking into account the amount of revenue expected to be raised by CSHB 3 and used to buy down future tax rates.

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.

Any additional revenue raised by CSHB 3 would be applied to reducing the tax rate for school districts. Additional funds would be appropriated out of a school property tax relief fund beginning in fiscal 2008 and continuing through fiscal 2010. By the effective date of CSHB 3, the comptroller would estimate the anticipated increase in state revenue attributable to CSHB 3 for fiscal years 2006 to 2011 and report that amount to the Legislature, the LBB, and the governor. Each subsequent September 30, the comptroller would report the actual additional revenue attributable to the bill. If the actual amount were greater than the estimated amount, the difference would be transferred to a school property tax relief fund, provided it did not reduce the amount of general revenue available for certification below the amount last certified.

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 of available state revenue to buy down tax rates in the calculation for a local tax rollback election, reducing the base for the calculation.

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 did 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.

CSHB 3 would ensure that if the state's finances improved or new state tax efforts raised more money than expected, continued school tax rate reduction would be the top priority. Fifteen percent of any additional state revenue would go toward reducing the tax rate. Also, amounts above the anticipated revenue generated by CSHB 3 would have to go toward continued tax relief. The first mechanism would capture improved state finances, including additional state revenue generated by CSHB 3. The second would ensure that all HB 3-related additional revenue was returned to taxpayers.

This proposal would put property tax reduction first. A wide range of interests compete when the state has additional money, including health and human services, criminal justice, transportation, and economic development, as well as increased funding for 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 priority 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.

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 greater than that for the previous biennium. However, after accounting for baseline budget needs, the extra growth was only $400,000. If this buy-down 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 had taken a substantial slice of any extra revenue available.

This provision would deplete growth in state finances and become 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 tied up by this buy-down provision, legislative budget writers could be forced into a fiscal strait jacket even as population demands rose and costs increased. In times of declining revenues, the effect would be even more profound, with the Legislature forced to use a large portion of its available revenue for school tax cuts because it would be locked in to spending at least what it spent the previous biennium for additional property tax relief.

CSHB 3 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 the buy-down provision because it would take revenue generated by the state from a variety of sources and return it 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 have less. Even though all Texans pay into state revenue through sales taxes, fees, and other consumption taxes, only the wealthiest would benefit overall from this provision.

The appropriations process works best without hamstringing budget writers. According to the analysis in the governor's 2004 school finance plan, it took almost a decade for 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, might 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 statute, to ensure that future lawmakers did not make a practice of suspending the dedication whenever it was convenient. A simple majority vote would be too low a hurdle for circumventing such an important part of the tax relief package.

A more appropriate way to ensure that property taxes do not return to the high levels that exist today would be to require a fixed proportion of state funding for education. If the state were required to match local dollars at a certain level, there would be no opportunity for rates to creep back up. While it would limit future lawmakers' flexibility in allocating funds, it would retain their authority to decide the relative proportion of funding for priorities within the education system.

RENDITION VERIFICATION

BACKGROUND: Tax Code, sec. 22.01 requires a person to render for taxation all tangible personal property used for the production of income, including inventory. A rendition statement must include a description of the property, the physical location of the property, and the property owner's estimate of the market value of the property. Sec. 22.28(a) imposes a penalty of 10 percent of the total amount of taxes imposed on property on a person who fails to file a rendition statement in a timely manner.

DIGEST: CSHB 3 would authorize a chief appraiser or an authorized representative employed or retained by the appraiser to request that a property owner provide forms filed by the property owner with the Internal Revenue Service relating to the cost and acquisition of fixed assets. Within 21 days of receiving such notice, the property owner would have to make available those documents for inspection. This information would be used to verify the location and valuation of tangible personal property for inclusion on an appraisal roll. Documents made available under the bill would be confidential.

For an individual who failed to file a rendition statement, a lien in the amount of the penalty would be attached to property on which the penalty was imposed. A delinquent penalty would accrue penalties and interest in the same manner as a delinquent tax.

An appraisal district could contract with an authorized representative to perform rendition verification services. That representative could not perform a field visit to verify assets. Compensation to an authorized representative could not exceed 20 percent of the value of any tax, penalty, or interest on underreported assets verified by the agent.

A chief appraiser would have to submit a report to the commissioner of education by July 31 of each year stating the increased value added as a result of rendition verification for each school district in the appraisal district. The education commissioner would adjust distributions from the Texas education fund to a school district based on increases in reported value.

The bill would define an "asset verification agent" as a person employed by an appraisal district to verify the valuation of income-producing property for the purposes of inclusion on an appraisal roll. In order to perform those services, an agent would have to hold a certificate of registration with the Texas Commission of Licensing and Regulation.

SUPPORTERS SAY:

By implementing rendition verification reforms, CSHB 3 would ensure compliance with the law that requires a business to voluntarily render its taxable personal property for taxation. In 2003, the 78th Legislature created penalties for businesses that failed to render taxable personal property in a timely and accurate manner but did not create a mechanism for appraisers to verify the accuracy of the renditions. This provision in CSHB 3 would give appraisers a mechanism that has been successfully used in other states to verify that rendition is accurate. While it would permit the appraiser confidentially to use the business's documents to verify the accuracy of the rendition, it would not allow appraisers to audit the business.

The current system is not working, as evidenced by the low amount of reported taxable business personal property in Texas. In 2004, the reported taxable business personal property in Texas was approximately half that of Florida, North Carolina, and Georgia on a pro rata basis.

OPPONENTS SAY:

By granting private contractors the authority to demand IRS documents from property owners, CSHB 3 would provide unprecedented investigative powers to private individuals. This "bounty hunter" provision would create incentives for private "asset verification agents" to trawl government documents for alleged undervaluation of property, without incorporating safeguards to ensure that companies were protected from frivolous claims by those contractors. The bill could allow a private agent to submit an inaccurate claim that a business had undervalued its property, and the business might be compelled simply to settle the case rather than challenge the false rendition in court.

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" (out-of-state) 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 fiscal 2006-07 at more than $3.8 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.

In recent years, some large Texas-based firms have reorganized as partnerships under state law. As such, they no longer must pay the franchise tax. Examples include Dell Computer and SBC Communications. Firms accomplish this by forming wholly owned out-of-state subsidiaries, usually in tax-friendly states such as Delaware – hence, the resulting entity has been nicknamed "the Delaware sub." Typically, the subsidiaries enter into limited partnerships wherein the general corporate partner owns 0.1 percent of the operating assets in Texas and the limited partners own 99.9 percent. Under the comptroller's administrative rules, foreign corporations acting as limited partners are not considered to be doing business in Texas for tax purposes and thus are not subject to the franchise tax. The franchise tax liability of the general partner corporation typically is zero because its 0.1 percent interest fails to generate total receipts greater than the $150,000 income threshold.

A second accounting method used by some large firms is termed the "Geoffrey" loophole, named after the Toys R Us Inc. giraffe mascot. Under this method, corporations establish a subsidiary in another state that charges the Texas operations for the use of certain intangible assets, such as corporate trademarks. This methods diverts money out of the Texas operations, and the franchise tax is applied only to what remains.

DIGEST:

Corporate ownership in partnerships. Effective November 1, 2005, the franchise tax would be imposed on a foreign corporation that:

- held a partnership interest in a general partnership doing business in Texas;
- held a partnership interest as a general partner in a limited partnership doing business in Texas; or
- held a controlling interest as a limited partner in a limited partnership doing business in Texas.

"Partner" would include a beneficiary in a trust, and "partnership" would include a partnership, a joint venture, and a trust.

A partner who owned an upper-tier partnership would be considered a partner in the upper-tier partnership as well as each lower-tier partnership. A partner would be considered a controlling interest if any related party owned a controlling interest in the partnership, either directly or indirectly. "Related party" would be defined as a person or entity that owned a controlling interest in another entity. This would include an entity that was treated as a pass-through or disregarded entity. The comptroller would be directed to adopt rules to further define "related party."

If a partner asserted that taxation under the bill violated the U. S. Constitution or federal law, the franchise tax would be imposed on the partnership doing business in Texas. In this case, the entity's reportable federal taxable income would be defined as the partnership's income to the extent that the partnership was owned by a corporation.

In determining a corporation's taxable earned surplus, a corporation would have to include in its gross receipts the corporation's share of the gross receipts of each partnership or joint venture in which the corporation directly or indirectly owned an interest. For a corporation that owned an interest in an upper tier partnership, the corporation's share of gross receipts would be computed as though the corporation directly earned receipts at the tier at which the receipts originally were earned. A corporation would include its share of a partnership's income or loss for computation of net taxable earned surplus, regardless of whether the partnership was taxed as a corporation for federal income tax purposes.

Application to partnerships. The bill would include additional provisions that would take effect if a court ruled that the changes to the taxation of foreign corporations violated the U. S. Constitution. In the event of such a ruling, the bill would impose a franchise tax on each general partnership doing business in the state that was owned directly or indirectly by a corporation. The tax also would be imposed on each limited partnership doing business in the state to the extent that the general partner's interest in the limited partnership was directly or indirectly owned by a corporation. The tax also would be imposed on each limited partnership controlled by a corporate limited partner doing business in the state to the extent that the limited partnership was owned directly or indirectly by the controlling limited partner. The definition of "corporation" would be expanded to include a partnership.

Provisions in current law providing the comptroller with the right to forfeit the corporate privileges of a corporation also would apply to a partnership subject to the franchise tax.

Add-back of certain payments. A corporation would have to add back to its reportable federal taxable income any royalty payments, interest payments, or management fees made to a related party. A corporation would not have to add back royalty payments to a related party to the extent that:

- the related party directly or indirectly paid or incurred the amount to an entity that was not a related party, the transaction was done for a valid business purpose, and the payments were made at "arm's length"; or

- the royalty payments were paid or incurred to a related party that was organized under the laws of a foreign nation, subject to an income tax treaty between that nation and the U.S. government, and taxed in the foreign nation at a rate at least equal to the rate of the franchise tax rate on earned surplus.

"Arm's length" would mean a relationship in which unrelated parties that had equal bargaining power and acted in their own interests negotiated or carried out a particular transaction.

A corporation would not have to add back interest payments to the extent that:

- the interest rate was no more than the applicable federal rate compounded annually for debt instruments issued for property, as governed by the Internal Revenue Code; or
- the related party directly or indirectly paid or incurred the amount to an entity that was not a related party, the transaction was done for a valid business purpose, and the payments were made at arm's length.

A corporation would not have to add back a royalty payment or an interest payment made to a related party, or a management fee paid to a related party, if the combined tax rate paid to this state or other states exceeded the tax that would have been paid by the corporation if the payment had not been made. A corporation would not have to add back a management fee paid to a related party if the transaction was done for a valid business purpose and the fee was paid at arm's length.

The comptroller could allocate gross income, deductions, credits, or allowances among organizations or business as if:

- the organizations were owned or controlled directly or indirectly by the same interests; and
- the comptroller determined that the allocation was necessary to reflect an arm's length standard or reflect the income of those organizations.

Transitional provisions. Income or losses occurring before January 1, 2005, of a corporation that became subject to the franchise tax under the bill would not be considered under the earned surplus component of the tax. A corporation subject to the earned surplus component between October 31, 2005, and January 1, 2006, but not subject to the earned surplus component on January 1, 2006, would have to file a final report computed on net taxable earned surplus.

SUPPORTERS SAY:

By closing the current "Delaware sub" and "Geoffrey" loopholes, CSHB 3 would address a serious shortcoming with Texas' largest business tax. The franchise tax has proven to be a stable source of revenue and has weathered well, even during economic downturns. The primary problem with the current tax is that many businesses have been able to reorganize as partnerships in order to avoid the tax. Many large, profitable businesses such as Dell and SBC do not pay the tax. These and other companies rightly would be drawn into the franchise tax under CSHB 3, reinforcing this revenue stream that is so important for state government.

Retaining the current franchise tax and closing its loopholes would be a better option than other business tax proposals. The franchise tax is a well established source of revenue that the state has relied upon for decades. A new business tax on payrolls or gross receipts that applied to all income-producing entities could cause a serious disruption in the state's economy, potentially harming investment or exacerbating unemployment. Further, given the constitutional prohibition on the taxation of personal income, any payroll-based tax or tax on sole proprietors would be challenged in court and could be ruled unconstitutional. Given these uncertainties, it would be imprudent for the state to rely upon an unproven and potentially unconstitutional system of business taxation to fund vital government services.

It is unlikely that companies brought into the tax system under CSHB 3 would reorganize further to avoid taxation under the bill. The modes of business organization left untaxed in CSHB 3, such as sole proprietorships, would be unsuited for the large firms brought into the tax system under the bill. The comptroller stated that the language in this bill would capture approximately 10,000 firms currently untaxed and would generate approximately $864 million in revenue in fiscal 2006-07. Even in the unlikely event that a new tax loophole later emerged, the Legislature could address that issue if and when it occurred.

OPPONENTS SAY:

By retaining the inequitable and problematic franchise tax, CSHB 3 would squander an important opportunity to truly revamp the state's outmoded system of business taxation. Even with the closure of current loopholes, the base of the franchise tax would be very narrow and the tax would continue disproportionately to burden capital-intensive industrial and mercantile enterprises. The state's rapidly growing service and information economy largely would continue to escape taxation.

The business tax included in HB 3 as introduced would be a more equitable and effective method for the state to levy taxes on companies operating in the state. That proposal would have provided companies with a choice between a tax on capital and surplus or a tax on payroll, depending on the type of tax most suitable to each business and would have captured 475,000 businesses in total. The system also would have incorporated a floor such that no business could pay less than 50 percent of the capital/surplus option, ensuring that no business would escape taxation entirely. It would be unfortunate if the Legislature allowed this opportunity to slip by without modernizing the state's tax structure to reflect the changing nature of the Texas economy.

Recent history has shown that determined accountants and attorneys are able to identify loopholes and invent new forms of organization to avoid taxation under the franchise tax. This fact would remain even with the reforms of CSHB 3. Anything short of a tax applicable to all business organizations operating in the state would leave opportunities for new loopholes to emerge in the future.

OTHER OPPONENTS SAY:

Art. 8, sec. 24(a) of the Texas Constitution requires a binding statewide referendum on any law that imposes a tax on net income, "including a person's share of partnership and unincorporated association income." This provision could lead a court to declare the provisions of CSHB 3 unconstitutional in the likely event that they were challenged. For this reason, the franchise tax expansion in the bill should be put to a public vote in accordance with the Constitution. Such a vote would clarify the will of the electorate with regard to taxation of businesses and individuals in the state.

SALES TAX

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 increased 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 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 7.95 percent, according to the Sales Tax Clearinghouse. It reports that the national average combined rate is 6.25 percent. At 7.95 percent, Texas currently is tied with Alabama, Arkansas, and California for the sixth-highest average combined rate. The top five in descending order are Tennessee, 9.4 percent; Louisiana, 8.55 percent; Washington, 8.35 percent; New York, 8.2 percent; and Oklahoma, 8.1 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 1.2 percent. At 6.25 percent, Texas is tied with Illinois for the seventh 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 state 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 state 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 state 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 state sales tax on taxable boats and boat motors bought in Texas (sec. 160.021(b)) and a 6.25 percent state 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. Under sec. 151.009 computer programs are considered tangible personal property and are taxed.

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). Under the “timely filer deduction” – Tax Code, sec. 151.423 – a taxpayer that remits to the comptroller in a timely fashion taxes that are due can deduct 0.5 percent of the amount 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 general sales and use tax rate from 6.25 percent to 7.25 percent. Water sold in sealed containers would be taxable. Motor vehicle repair services also would be taxed. 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.

The bill would eliminate the timely filer deduction.

It would broaden the definition of “computer program” to include a computer program developed exclusively for a client who retained all rights to the program. The bill would define “motor vehicle repair services” 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.

SUPPORTERS SAY:

Sales taxes remain one of the most stable and reliable revenue sources, tracking a wide variety of economic activities in the state conducted both by individuals and businesses. 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 bordering 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 can 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 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 generally is discretionary. Bottled water sales should be taxed like other bottled beverages.

The service industry primarily recirculates 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 revenue 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.

Repealing the timely filer discount would make the tax collection system more consistent as companies already are required to file by certain deadlines. Rewarding them for complying with the law is not the best use of state funds. Instead, companies that file in accordance with the law should be rewarded by avoiding fines and penalties.

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 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.

Consumers in Texas' still shaky economy would have to pay state sales tax at a rate of 7.25 percent and 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, with the rate in most urban areas as high as 9.25 percent.

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 bottled water 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.

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 online 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 Congress will continue this exemption, particularly given the current size of the federal budget deficit.

Repealing the timely filer discount would penalize companies that currently pay in accordance with the required timelines. Companies that have large credit card receipts, in particular, would take the biggest hit because their revenue is diminished by the fees charged by credit card companies. For example, a retailer that submits a credit card bill for $100 receives less back because of fees. The amount of sales tax the retailer must pay is not reduced, however, and the difference is made up through lower margins. The timely filer discount makes up part of the difference.

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 Internet 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

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 September 1, 2005, if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect on the 91st day after the end of the special session (October 19, 2005, if the first called session lasts the full 30 days).

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 individuals who pay a discounted price for damaged vehicles might be taxed inappropriately at an inflated rate value would be avoided under this provision.

OPPONENTS SAY:

This 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 was not correct because the vehicle was not in running condition or was 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 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 daily. 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 1.25 cents per 10 or less. Rates per thousand for the three categories of larger cigars would rise from $7.50 to $9.375, from $11 to $13.75, and from $15 to $18.75. The OTP tax rate would rise from 35.21 percent to 40 percent of the manufacturer's list price.

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

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.

COLLECTION OF STATE DELINQUENT OBLIGATIONS

BACKGROUND:

Under Government Code, sec. 2107.003, delinquent obligations, including taxes, fees, or other payments owed to a state agency, must be turned over to the attorney general before an agency can retain a third-party debt collector. If a debt cannot be collected by the attorney general, the agency may then retain the services of a third-party debt collector.

DIGEST:

CSHB 3 would require state agencies to report delinquent obligations to the attorney general for collection within 120 days of the debt becoming past due. The attorney general would provide legal services for the collection or could contract with a third-party to collect the obligation. In addition to the original debt, interest, and penalties, the state agency also could collect the cost of recovery, which could be set under contract with a third-party of up to 30 percent of the total obligation.

The state could require a contractor to pursue judicial action but would not be liable for any costs, fees, or security bonds. It also would require that any contractor obtain insurance and post a bond in the amount of any state revenue or property that it was expected to obtain. The bill also would establish grounds for termination of a contract, information sharing, and the legal standing of a contractor.

SUPPORTERS SAY:

CSHB 3 would improve collection of unpaid state debt by consolidating collection efforts for most agencies at the attorney general's office and establishing a single set of contracting policies. According to the LBB, this provision could generate $17 million in fiscal 2006-07.

OPPONENTS SAY:

No apparent opposition.

NOTES:

HB 3 as introduced would have reduced the maximum ad valorem tax rate for school districts to $1.10 per $100 of taxable property value beginning with the 2006-07 school year, with a potential reduction to $1.15 per $100 beginning with the 2005-06 school year if CSHB 3 and HB 2 by Grusendorf received a vote of two-thirds of both houses of the Legislature.

The bill as introduced would have eliminated the current franchise tax and replaced it with a new reformed franchise tax. This new business tax would have provided taxable entities with a choice between a tax of 1.15 percent of the company's taxable wages or the greater of 0.25 percent per year on taxable capital or 4.5 percent on earned surplus. The reformed franchise tax would have included a floor such that no entity could pay less than 50 percent of the amount of tax that the entity would have paid on the capital/surplus tax option. "Taxable entity" would have included corporations, partnerships, and any other entity doing business and organized in the state, but would have excluded several types of passive investment, real estate investment, and certain other trusts and partnerships.

Other provisions of the committee substitute not contained in the filed version of HB 3 include rendition verification, collection of outstanding state obligations, and a tax of 40 percent on other tobacco products rather than 44.02 percent.

According to the LBB, the bill would have a positive impact of $8.24 billion to general revenue-related funds through fiscal 2006-07 if it went into effect on September 1, 2005. The bill would have a positive net impact of $7.46 billion to general revenue-related funds through fiscal 2006-07 if the effective date was November 1, 2005. Nearly all of this total would offset the reduction of local property taxes to $1.12, with a net increase of approximately $199 million in fiscal 2007.