SUBJECT: Exempting from the franchise tax web hosting for out-of-state customers

COMMITTEE: Ways and Means — favorable, without amendment

VOTE: 7 ayes — Hilderbran, Otto, Bohac, Button, Eiland, N. Gonzalez, Ritter

0 nays

1 absent — Martinez Fischer

1 present not voting — Strama

WITNESSES: For — Chris Rosas, Rackspace; (*Registered, but did not testify:* George Christian, Texas Taxpayers and Research Association; Robert Flores, Texas Association of Mexican-American Chambers of Commerce; John Montford, Rackspace Hosting; Patricia Morse, SoftLayer Technologies, Inc.; Drew Scheberle, Greater Austin Chamber of Commerce; Carlton Schwab, Texas Economic Development Council; David Kaplan)

Against — (*Registered, but did not testify:* Ted Melina Raab, Texas AFT)

On — (*Registered, but did not testify:* Teresa Bostick and Ed Warren, Texas Comptroller of Public Accounts)

BACKGROUND: The Texas franchise tax, or "margins" tax, applies to each taxable entity that does business or is organized in the state. The tax is calculated as either 1 percent or 0.5 percent of taxable margin.

In general, a taxable entity's margin is apportioned to the state to determine the amount of tax imposed by multiplying the margin by the fraction of the entity's total receipts that are from doing business in the state.

Tax Code sec. 151.108 defines "internet hosting" as providing access to computer services using property that is owned or leased and managed by a provider on which a user may store or process the user's own data or use software that is owned, licensed, or leased by the user or provider. The term does not include telecommunications services.

DIGEST: HB 416 would provide that a receipt from Internet hosting described by Tax Code, sec. 151.108 was a receipt from business done in the state only if the customer was located in the state.

The bill would take effect September 1, 2013, and would apply to a franchise tax report due on or after that date.

SUPPORTERS SAY: HB 416 would put Texas in a more competitive position to recruit businesses in the web hosting industry. The bill would address the limits of current tax franchise tax law to fairly tax new and emerging industries.

Web hosting businesses, such as Rackspace, offer a range of cloud computing services to an international customer base. Cloud computing makes use of large, monitored servers housed in facilities all over the world. Because server storage facilities are geographically unconstrained, web hosting businesses carefully weigh state tax structures when deciding where to locate facilities.

The unique nature of Texas' franchise tax yields a higher tax burden on web hosting businesses than they encounter in many other states. In general, web hosting businesses have relatively low costs for compensation or cost of goods sold, which are the primary deductions available to businesses under the franchise tax. Instead, the greatest expenses of web hosting businesses are capital investments in facilities and servers, and research and development, which are not deductible under the franchise tax.

In addition, under the franchise tax, the state's apportionment formula, which determines the portion of a company's receipts that are from business done in the state and therefore subject to tax, generally returns a high percentage of taxable receipts for web hosting companies in Texas. This is because receipts from out-of-state customers paying for web storage in Texas are treated as business done in this state for the purposes of the apportionment formula. As such, web hosting businesses have a higher percentage of their receipts subject to tax than other businesses with large out-of-state customer bases.

Any fiscal impact of HB 416 would be more than offset by increased investment from web hosting companies in the state. If current law were to remain in effect, this rapidly growing industry will expand in other states at the expense of Texas. In that case, the state will generate from the industry little revenue or investment of any kind, an ultimate loss for taxpayers.

OPPONENTS SAY:

HB 416 would have an indirect impact on general revenue funds by reducing franchise tax funds flowing to the Property Tax Relief Fund, which was established by the Legislature in 2006 to offset reductions of school property taxes. It would reduce taxes collected for public schools by about $5 million for fiscal 2014-15 and beyond, according to the Legislative Budget Board. Because revenue in the Property Tax Relief Fund is dedicated to public education, any reduction of revenue in the fund must be offset with general revenue funds.

The Legislature should not contemplate measures that reduce funds available for public education without first restoring the deep cuts it made to schools in 2011. Until these cuts are restored, any proposal to reduce revenue coming in to the state that is not absolutely necessary should be tabled.

A growing number of companies offering cloud computing services and products likely would fall under the definition of “web hosting” in the bill. By removing transactions involving out-of-state customers from the franchise tax apportionment calculation, the state could be setting itself up for a significant loss of future revenue that may not be accounted for in current fiscal projections.

OTHER OPPONENTS SAY:

While the intent of HB 416 may have merit, it would continue the state’s piecemeal approach to the seemingly endless issues that plague the franchise tax. Under the current tax, many businesses are taxed on expenses that should be exempt, others pay unequal rates for similar activities, and still others have to pay taxes for years where they actually report a net loss of income. The Legislature should embrace comprehensive reform or elimination of the deeply flawed franchise tax and move away from the ad hoc approach to fixing its various problems.

NOTES:

The Legislative Budget Board estimates the bill would result in a revenue loss to the Property Tax Relief Fund of $5 million for fiscal 2014-15. Any loss to that fund must be made up with an equal amount of general revenue to fund the Foundation School Program.

The companion bill, SB 1518 by Van de Putte, has been referred to the Senate Finance Subcommittee on Fiscal Matters.