LEGISLATIVE BUDGET BOARD
Austin, Texas

FISCAL NOTE, 79TH LEGISLATURE 1st CALLED SESSION - 2005

July 8, 2005

TO: Honorable Steve Ogden, Chair, Senate Committee on Finance

FROM: John S. O'Brien, Deputy Director, Legislative Budget Board

IN RE: **HB3** by Keffer, Jim (Relating to financing public schools in this state and reducing property taxes.), **Committee Report 2nd House, Substituted**

Estimated Two-year Net Impact to General Revenue Related Funds for HB3, Committee Report 2nd House, Substituted: a positive impact of $6,193,580,000 through the biennium ending August 31, 2007, if the effective date of the bill is September 1, 2005; or a positive impact of $5,781,312,000 through the biennium ending August 31, 2007, if the effective date of the bill is November 1, 2005.

The following assumes a September 1 or October 1, 2005 effective date.

All Funds, Five-Year Impact:

Fiscal Year	Probable Revenue Gain/(Loss) from *GENERAL REVENUE FUND* 1	Probable Revenue Gain/(Loss) from *STATE HIGHWAY FUND* 6	Probable Revenue Gain/(Loss) from *FOUNDATION SCHOOL FUND* 193	Probable Revenue Gain/(Loss) from *School Districts*
2006	$2,002,291,000	$1,852,000	$0	($2,009,609,000)
2007	$157,326,000	$2,331,000	$4,033,963,000	($4,421,914,000)
2008	$293,955,000	$2,447,000	$4,336,031,000	($4,605,420,000)
2009	$362,667,000	$2,569,000	$4,539,389,000	($4,789,644,000)
2010	$245,820,000	$2,697,000	$4,778,633,000	($5,786,708,000)

Fiscal Year	Probable Revenue Gain/(Loss) from *Cities*	Probable Revenue Gain/(Loss) from *Counties/Special Districts*	Probable Revenue Gain/(Loss) from *Transit Authorities*
2006	$18,163,000	$7,891,000	$4,201,000
2007	$25,491,000	$9,515,000	$6,462,000
2008	$32,003,000	$10,538,000	$8,625,000
2009	$33,846,000	$10,989,000	$9,179,000
2010	$35,799,000	$11,452,000	$9,770,000

The following assumes a November 1, 2005 effective date.

Fiscal Year	Probable Revenue Gain/(Loss) from *GENERAL REVENUE FUND* 1	Probable Revenue Gain/(Loss) from *STATE HIGHWAY FUND* 6	Probable Revenue Gain/(Loss) from *FOUNDATION SCHOOL FUND* 193	Probable Revenue Gain/(Loss) from *School Districts*
2006	$1,590,023,000	$1,296,000	$0	($2,009,609,000)
2007	$157,326,000	$2,331,000	$4,033,963,000	($4,421,914,000)
2008	$293,955,000	$2,447,000	$4,336,031,000	($4,605,420,000)
2009	$362,667,000	$2,569,000	$4,539,389,000	($4,789,644,000)
2010	$245,820,000	$2,697,000	$4,778,633,000	($5,786,708,000)

Fiscal Year	Probable Revenue Gain/(Loss) from *Cities*	Probable Revenue Gain/(Loss) from *Counties/Special Districts*	Probable Revenue Gain/(Loss) from *Transit Authorities*
2006	$14,639,000	$6,429,000	$3,361,000
2007	$25,491,000	$9,515,000	$6,462,000
2008	$32,003,000	$10,538,000	$8,625,000
2009	$33,846,000	$10,989,000	$9,179,000
2010	$35,799,000	$11,452,000	$9,770,000

Fiscal Analysis

The bill would amend state law relating to the financing of public schools and the reduction of school property taxes.

Article 1 would lower school district maintenance and operations (M&O) property tax rate limits. The bill would reduce the school district M&O rate limit in from the current $1.50 limit to $1.30 in tax year 2005, $1.11 in tax years 2006 through 2008 and $1.05 in tax year 2009 and each year thereafter. For each year, the limit is increased by $0.15 for enrichment, contingent upon local voter approval. Part A would take effect September 1, 2005 and apply beginning with the 2005-06 school year.

Article 2 would amend several provisions of Chapter 171 of the Tax Code. Part A would expand the type of business entities subject to the franchise tax to include corporations holding certain partnership interests. Net taxable capital and net taxable earned surplus are redefined to include a corporations' share of certain partnership interests or income.

Part B defines the franchise tax's application to partnerships. Part B becomes law if only a final judgment that the franchise tax violates the U.S. Constitution or federal law because of the application of new Section 171.001(d-1) of the Tax Code.

Part C would require that taxable entities add-back to reportable federal taxable income certain payments made to related entities. The bill would specify safe harbors for the add-back of royalty and interest payments. The bill would grant the Comptroller authority to adjust items of income and deductions among related parties if such adjustment were necessary to reflect an arm's length standard.

Part D contains transition language for Parts A, B and C, and provides that those parts become effective November 1, 2005 and apply to reports originally due on or after that date.

Part E would expand the definition of a business required to pay the franchise tax to "taxable entity." A taxable entity would include a general partnership, limited partnership, limited liability partnership, corporation, banking corporation, savings and loan association, limited liability company, trust, business trust, professional association, joint venture, joint stock company, holding company or other legal entity. Taxable entity does not include a sole proprietorship or a passive entity defined as a limited partnership or a trust, other than a business trust, that makes no wage payments and that receives at least 90 percent of its income from interest, dividends, real property rents, gains from sales of securities and properties, or mineral royalties and other nonoperating mineral interests on assets acquired and held for investment.

The tax rate on earned surplus would drop from 4.5 percent to 4.25 percent. The earned surplus tax base would include all compensation as reported on a specified line on the federal Internal Revenue Service Form 940, Employers' Annual Federal Unemployment (FUTA) Tax Return. A taxpayer could deduct the lesser of 90 percent of its compensation or $30,000 per full-time employee. Taxable compensation would include guaranteed payments to partners. Taxpayers served by a staff leasing company would add to their earned surplus the payments made by the staff leasing company to employees assigned to the taxpayer's business. The staff leasing company would subtract such payments from its own earned surplus. The reportable federal taxable income for a partnership and other noncorporate taxable entities would be determined under rules adopted by the Comptroller, using principles similar to the standard applied to corporations.

The bill would allow a parent or investor taxable entity to exclude from its taxable capital the investment in the capital of other taxable entities if the parent or investor had a controlling interest in the other entities.

The bill would establish a franchise tax credit for physicians, dentists, optometrists, and podiatrists participating in the Medicaid or Children's Health Insurance Program (CHIP) as providers of health care services. The credit would be equal to 20 percent of the payments received from the programs. The credit would be nontransferrable and limited to the amount of tax due. The Comptroller, with the assistance of the Health and Human Services Commission, would adopt rules to implement the credit.

The bill would change the reference to the Internal Revenue Code from the one in effect after January 1, 1996 and before January 1, 1997 to January 1, 2005;add provisions on the forfeiture of the right of a partnership to transact business in the state; permit noncorporate taxable entities to qualify for refunds and credits on the same basis as currently exist for corporations; specify that the revenue from the franchise tax be deposited in GR Account 0193—Foundation School; and repeal various provisions in Chapter 171 concerning officer and director compensation.

This part would take effect January 1, 2007 upon approval by voters in a statewide referendum held November 8, 2005, and apply to reports originally due on or after that date. For entities that would become subject to the tax because of this article, income or losses occurring before January 1, 2006 could not be considered for the earned surplus component. An entity that would become subject to the tax because of this article and that would be subject to the tax on January 1, 2007, and for which January 1, 2007 is not the beginning date, would file an annual report due May 15, 2007.

Article 3. This article would amend the Tax Code relating to sales and use taxes. Part A would amend Chapter 151 to raise the state sales and use tax rate to 6.75 percent from 6.25 percent. The definition of computer program for sales tax purposes would be clarified to include a computer program created or developed exclusively for a client who retains all rights to the program, and the exemption for the repair, maintenance, creation and restoration of a computer program is repealed. There would be a prior contract exemption for sales taxes imposed as a result of this Act.

Part A also would provide sales tax relief to persons receiving financial assistance under Chapter 31 of the Human Resources Code or nutritional relief under Chapter 33 of the Human Resources Code through an electronic benefits transfer system. In addition, an individual otherwise eligible for financial assistance under Chapter 31, but for whom such assistance is not paid because of sanctions applied against the individual under Section 31.0032 would be eligible for reimbursement. The article would require the Comptroller and the executive commissioner of the Health and Human Services Commission (HHSC) by joint rule to devise a program to reimburse eligible persons for 20 percent of their estimated state sales taxes paid during each state fiscal year. The Health and Human Services Commission could not consider these reimbursements in determining a household's eligibility for state financial assistance and food stamps. No later than August 15 of each year, the Comptroller, by rule, would estimate the amount of state sales taxes an eligible person was expected to pay during the next state fiscal year, considering the persons' federal adjusted gross income (FAGI), the number of dependents for federal tax purposes, and any other information the Comptroller considered appropriate. Using this information, the Comptroller would devise a table specifying, by income bracket and number of dependents, the estimated amount of state sales taxes an eligible person would be expected to pay and the amount of reimbursement the individuals would be entitled to receive under this bill. The Comptroller would provide the table to the HHSC executive commissioner, who would use the table to provide either additional monthly financial assistance under Chapter 31, or additional monthly nutritional assistance to those receiving such under Chapter 33, if they were not receiving financial assistance under Chapter 31. HHSC would make these reimbursements available to eligible persons using the state's electronic benefits system. Notwithstanding any other law, however, the total amount of reimbursements under this bill could not exceed $100 million each state fiscal year. The bill would authorize the Comptroller and the HHSC executive commissioner to take any action necessary to ensure that the $100 million limit would not be exceeded, to include: decreasing the percentage of tax reimbursements paid, decreasing the amounts of monthly payments or assistance on a pro rata basis, or suspending the reimbursements.

Part A would take effect September 1, 2005, assuming the bill received the requisite two-thirds majority votes in both houses of the Legislature. Otherwise, it would take effect November 1, 2005.

Part B would amend Chapter 152 to raise the rates for the state motor vehicle sales tax and the motor vehicle rental tax (on rentals of more than 30 days) to 6.75 percent from 6.25 percent. The bill would establish a standard presumptive value for determining the proper amount of motor vehicle sales tax due on certain motor vehicle sales transactions. The Texas Department of Transportation (TxDOT) would determine the presumptive value based on a nationally recognized motor vehicle industry reporting service. TxDOT would maintain information on presumptive values as part of its registration and title system, update the values quarterly, and make the values available to county tax assessor-collectors no later than November 1, 2005. The standard presumptive value provisions would not apply to even-exchange or gift transactions. If the amount paid in a sales transaction were greater than or equal to the presumptive value, the tax assessor-collector would compute and collect the tax due on the amount paid. If the amount paid in a sales transaction were less than the presumptive value, the tax assessor-collector would compute and collect the motor vehicle sales tax due on the presumptive value, unless the purchaser could establish a retail value by obtaining an appraisal. Appraisals would have to be on a form prescribed by the Comptroller, and they would have to be obtained no later than the 20th day after purchase. Automobile dealers could charge a fee, set by the Comptroller, for providing a certified appraisal.

Part B would take effect September 1, 2005, assuming the bill received the requisite two-thirds majority votes in both houses of the Legislature. Otherwise, it would take effect November 1, 2005. The standard presumptive value provisions would take effect November 1, 2005.

Part C would raise the boat and boat motor sales and use tax rate to 6.75 percent from 6.25 percent. Part C would take effect September 1, 2005, assuming the bill received the requisite two-thirds majority votes in both houses of the Legislature. Otherwise, it would take effect November 1, 2005.

Article 4 would amend the Tax and Alcoholic Beverage Codes by raising the tax rates for cigarettes, cigars and other tobacco products, and alcoholic beverages.

Part A would raise the cigarette tax rate by $30.00 per 1,000 cigarettes weighing three pounds or less per thousand ($0.60 per pack of 20 cigarettes), to a new rate of $50.50 per 1,000 cigarettes ($1.16 per pack). Beginning September 1, 2007, the cigarette tax rate would increase to $70.50 per 1,000 cigarettes weighing three pounds or less per thousand ($1.00 per pack). Cigarette tax revenue generated by the rate increase would be deposited to the General Revenue Fund. In addition, Part A would amend Chapter 155 of the Tax Code to raise the tax rates for all of the tobacco products in the chapter by approximately 13.6 percent. The tax on small cigars (weighing three pounds or less per thousand) would increase to $0.0114 from $0.01 per 10 cigars; the tax on each of the three categories of large cigars ($7.50, $11.00, and $15.00 per thousand) would increase to $8.52, $12.50, and $17.04 per thousand, respectively; and the tax on tobacco products other than cigarettes and cigars (i.e., snuff and chewing and pipe tobacco) would increase to 40 percent from 35.213 percent of the manufacturer's list price. Cigar and tobacco products revenue generated by the rate increases would be deposited to Fund 1.

Part B would amend the Alcoholic Beverage Code to raise all alcoholic beverage excise taxes by 20 percent. The liquor tax would increase to $2.88 from $2.40 per gallon; the tax per gallon for each of the three categories of wine ($0.204 for table wine, $0.408 for fortified wine, and $0.516 for carbonated wine) would increase to $0.2448, $0.4896, and $0.6192, respectively; the tax on malt liquor (or ale) would increase to $0.2376 from $0.198 per gallon; and the tax on beer would increase to $7.20 from $6.00 per barrel. Alcohol excise tax revenue generated by the rate increases would be deposited to Fund 1. In addition, Part B would amend Chapter 183 of the Tax Code to raise the mixed beverage tax by 20 percent, to 16.8 percent from 14 percent of gross receipts. The state share of the mixed beverage tax revenue generated by the rate increase would be deposited to Fund 1.

This article would take effect September 1, 2005, assuming the bill received the requisite two-thirds majority votes in both houses of the Legislature. Otherwise, it would take effect November 1, 2005.

Unless otherwise provided for in this bill, this bill would take effect September 1, 2005, assuming that it received the requisite two-thirds majority votes in both houses of the Legislature. Otherwise, it would take effect November 1, 2005.

Methodology

Article 1 would compress school district M&O tax rates to $1.30 in fiscal 2006, $1.11 in fiscal 2007 through 2009, and $1.05 in fiscal 2010 and each year thereafter. The bill would allow a total of $0.15 enrichment. This estimate assumes no school district enrichment. School district M&O rates were set to the specified rates, applied to school district taxable values, and the result was trended through the projection period. The resulting reduced school district M&O levy was compared to the projected current-law levy to estimate the school district tax levy loss.

Article 2. The estimated fiscal impact was based on data from state franchise tax files and data from the Texas Workforce Commission.

Note: This analysis presumes voters give approval to the November, 2005 franchise tax referendum. Should voters disapprove, revenue losses from the foundation school account, when compared to the above tables, would be an estimated $1.76 billion in fiscal 2007, growing to an estimated $2.16 billion by fiscal 2010.

Article 3. The fiscal implications of raising the sales tax rate to 6.75 percent were estimated using current state sales and use tax revenue projections. The fiscal impact was adjusted for the two potential effective dates. The revenue gains for the State Highway Fund 6 reflect the increased sales tax revenue attributable to motor lubricants.

The fiscal implications of including certain computer services in the sales tax base were estimated using data gathered from the U.S. Census Bureau. Texas sales were multiplied by the sales tax rate, adjusted for the two potential effective dates, and extrapolated through fiscal 2010. The fiscal impact on units of local government were estimated proportionally.

The estimated fiscal impact of the sales tax reimbursements was based on Health and Human Services Commission data on the number of persons projected to receive assistance under Chapters 31 and 33 and their income and dependent characteristics. Using projections of the current IRS table showing allowable state sales tax deductions by Federal Adjusted Gross Income and number of dependents, the total amount of state sales taxes paid each year from fiscal 2006 to fiscal 2010 by persons eligible for reimbursements under this bill was estimated to be on the order of $508 million to $568 million per year.

Note: Article 3 would require the Comptroller to estimate the amounts of reimbursable taxes no later than August 15 of each year and to provide those results as soon as possible to HHSC. It was assumed, for the purposes of this fiscal note, that the Comptroller would nevertheless provide the required information to HHSC in time to allow the full amount of reimbursements, subject to the statutory cap, to be made in fiscal 2006. In addition, the $75 million cost to Fund 1 for the sales tax reimbursement assumes an appropriation of that amount would be made each year to HHSC.

The proposed motor vehicle sales tax rate was applied to estimates of annual gross sales subject to the motor vehicle sales tax and adjusted for behavioral effects. For the motor vehicle rental tax on rentals lasting more than 30 days, these long-term rentals represent approximately 5 percent of all rental tax revenue collected. The new rate was applied to estimates of adjusted gross rental tax and adjusted for behavioral effects. The presumptive value provisions would apply primarily to sales of motor vehicles between individuals, often referred to as "casual" or "private" sales. Even-exchanges or gifts of motor vehicles would be excluded. Estimated revenues for fiscal 2006 were adjusted for implementation lags.

The fiscal implications of raising the boat and boat motor sales tax rate to 6.75 percent were estimated using current boat tax revenue projections. The fiscal impact was adjusted for the two potential effective dates.

Article 4. The proposed cigarette, cigar and other tobacco products tax rate increases were estimated using current revenue projections for these taxes, adjusted for declines in taxable consumption in Texas, as well as for tax avoidance effects and collection lags.

The proposed alcoholic beverage tax rate increases were estimated using current revenue projections for these taxes, adjusted for declines in taxable consumption in Texas, as well as tax avoidance effects and collection lags. **Note:** As written, under this bill, counties and cities in which the taxpayers were located would receive increased allocations from the tax in accordance with current law—approximately 10.7 percent of increased collections to cities and a like amount to counties.

The Comptroller of Public Accounts estimates that positive dynamic fiscal impacts would result from this tax revision. Those impacts are not included in the tables above.

Not included in the above tables are administrative costs associated with implementing the provisions of the bill.

Local Government Impact

The fiscal impacts to local governments, including school districts, are reflected in tha above tables.

Source Agencies: 701 Central Education Agency, 304 Comptroller of Public Accounts, 307 Secretary of State, 320 Texas Workforce Commission, 362 Texas Lottery Commission

LBB Staff: JOB, SD, WP