

TAX FAIRNESS

Property Tax Relief for Texans



**Report of the Texas
Tax Reform Commission**

March 29, 2006

The Honorable Rick Perry
Governor, State of Texas
Texas State Capitol
Austin, Texas



Dear Governor Perry:

On behalf of the 24 members of the Texas Tax Reform Commission, I am pleased to present our final report.

You gave this Commission the formidable challenge of recommending reforms to the Texas tax structure that would provide significant and lasting property tax relief and that also would provide a stable and long-term source of funding for our schools. In carrying out the mission, we conducted 16 public hearings across the state, took oral testimony from an estimated 300 individuals and written testimony from many others.

We heard a wide range of suggestions on how Texas should restructure its tax system, including recommendations that we broaden the business tax, adopt a state personal income tax, collect only consumption taxes, and expand gambling. The Commission seriously considered numerous options, ultimately zeroing in on the recommendations enclosed in this report as the most positive, realistic, and appropriate direction for Texas tax policy. All this was considered in the glare of the court-imposed June 1st deadline, which ruled out constitutional changes due to the short timeframe.

This Commission undertook its charge knowing that its recommendations – if adopted – would have lasting consequences that would affect Texas for generations. I'm confident that you will find that our recommendations honor the principles you laid out for the Commission and I believe we have fulfilled the task you charged us with accomplishing. This task has been attempted for more than fifteen years, and we believe we have finally found the key to a fair and equitable revision of the franchise tax that will serve all Texans well in the future.

The task, while not easy, was a learning experience for everyone. On behalf of all members of the Commission, I thank you for the confidence you showed in us. Together we share a commitment to the future of this state and its schoolchildren.

Sincerely,

A handwritten signature in black ink, appearing to read "John Sharp". The signature is written in a cursive, flowing style.

John Sharp
Chairman, Texas Tax Reform Commission

TAX FAIRNESS

PROPERTY TAX RELIEF FOR TEXANS



JOHN SHARP,
CHAIRMAN

MARCH 2006

Presented to:
Governor Rick Perry
Lieutenant Governor David Dewhurst
Speaker Tom Craddick
Members of the 79th Texas Legislature



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ACKNOWLEDGMENTS

The Commission would like to publicly thank those individuals and institutions that made a successful endeavor possible. Particular appreciation goes out to the cities, chambers of commerce, businesses, and higher education centers that graciously provided venues for our meetings:

- Victoria College, Victoria
- Del Mar College, Corpus Christi
- Austin City Council
- El Paso City Council
- University of Mary Hardin Baylor, Belton
- Baylor Law School, Waco
- Texas Tech University, Lubbock
- Laredo Community College, Laredo
- South Texas College, Weslaco
- Texarkana College, Texarkana
- Hardin-Simmons University, Abilene
- Fredonia Hotel, Nacogdoches
- Commemorative Air Force, Midland
- San Antonio City Council
- Texas Southern University, Houston
- Wyndham Hotel, Arlington

We would also like to acknowledge the assistance of Commission staffers Robert Howden, Karey Barton, James LeBas, and Julie Nordling who, along with Andria Aguayo and Terri Wegner of the Governor's Office, kept the trains running and the data flowing. Finally, the counsel of the Governor's staff including Mike Morrissey, Deirdre Delisi, and Phil Wilson was invaluable as we considered the many options before us. Special thanks are due Haley Smith of Ernst & Young for lending her expertise on business tax topics.



EXECUTIVE SUMMARY

Governor Rick Perry directed the Commission to make recommendations on how to reform the state's business tax structure and provide significant property tax relief. Both goals are essential to promoting long-term economic growth and ensuring a stable, long-term source of revenue for public education. While many Texans advanced ideas other than the recommendations contained in this report, we believe our recommendations not only address the Governor's directive, but also meet later court-mandated improvements in how Texas funds its schools. Just as importantly, however, we believe these recommendations can achieve the bipartisan support of the Texas Legislature.

RECOMMENDATIONS

- I. The Legislature should cut school district property taxes for maintenance and operations substantially. With many districts setting rates at or near \$1.50 per \$100 of valuation, Texans are clearly paying too much in property taxes. The rate should be lowered to \$1 per \$100 and permanently re-capped at no more than \$1.30 per \$100 by the 2007 tax year. Reductions for the 2006 tax year sufficient to comply with the Supreme Court's mandate must be provided immediately.

- II. The Legislature should reform the state's franchise tax by:
 - Broadening the base of businesses that pay into the system and eliminating loopholes that have allowed many businesses to avoid paying their fair share.

 - Cutting the franchise tax rate from 4.5 percent to 1 percent and changing the underlying base of the franchise tax.

 - Basing the franchise tax on a business' margin by allowing each business to choose between two calculations: deducting either the cost of goods sold or employee compensation (including health insurance, pensions and other benefits) from its total revenue.

 - Doubling the small-business exemption from \$150,000 to \$300,000 in total revenue and exempting sole proprietors and non-corporate general partnerships.

- III. The Legislature should raise tobacco taxes, including raising the tax on cigarettes by \$1 per pack.
- IV. The Legislature should implement anti-fraud measures to boost state tax collections, including increasing the Comptroller's audit and enforcement activities and implementing an improved tax system for the sale of used cars.
- V. The Legislature should use a portion of the state surplus to buy down property taxes. Using some of the state's surplus would avoid the need for increases in other fees and taxes, such as the state's sales tax, which is already among the highest and broadest in the nation.

BENEFITS OF THE RECOMMENDATIONS

Texans will get a \$6 billion reduction in property taxes – the largest property tax reduction in history.

Home ownership would be more affordable for millions of Texans.

Recommended reforms to the franchise tax would encompass a broader cross-section of the state economy and be a fundamentally fairer way of funding our children's education or providing additional property tax relief.

The reforms to the existing franchise tax would apply to those businesses with state-provided liability protection, as was originally intended.

Unlike earlier proposals for franchise tax reform, businesses would be rewarded for creating more jobs and providing health care and pensions.

The state would pick up an estimated 50 percent of the costs of funding public education, a dramatic increase over the 34% level expected for fiscal 2007.

Doubling the small-business exemption from \$150,000 to \$300,000 in total revenue would help small businesses prosper and grow.

The plan would reduce the amount of money recaptured and re-directed to other school districts by Robin Hood.



MEMBERSHIP OF THE COMMISSION

John Sharp of Austin is a principal at Ryan & Company, a Dallas-based tax consulting firm, and he chairs the Texas Tax Reform Commission. In 1990 Mr. Sharp was elected Texas Comptroller of Public Accounts. During his eight years of service in that office he initiated many innovative programs, including the Texas Performance Review, the Texas School Performance Review, the Texas Tomorrow Fund and the Lone Star Card, all of which still benefit the state today. He was elected to the Texas House of Representatives, representing Victoria and Calhoun counties, and was later elected as a State Senator from South Texas. In 1985 he was elected to the Texas Railroad Commission where he served a four-year term. A graduate of Texas A&M University where he was elected class president as well as student body president, he also earned a master's degree in Public Administration from Texas State University while working full time at the Legislative Budget Board in Austin.

Truman Arnold of Texarkana is chairman of the board of Truman Arnold Companies, a privately-owned regional petroleum marketing company. Arnold is a National Advisory Council member on the National Petroleum Council. He is also a member of the Society of Independent Gasoline Marketers of America, the Petroleum Marketers Association of America, the Texas Oil Marketers Association and the Arkansas Oil Marketers Association. Arnold is chairman of the board of directors of Christus St. Michael Health System in Texarkana and of the Texarkana College Foundation board. He is former president of the Texarkana Chamber of Commerce. Arnold received his bachelor's degree from Lamar University in Beaumont.

William B. Blaylock of Dallas is vice president and tax director at Texas Instruments (TI), where he is responsible for the administration of TI tax matters, including public policy issues involving taxation. He also has been a member of TI teams that analyzed site selection decisions for manufacturing facilities in the U.S. and abroad. Blaylock has served as the chairperson and in other capacities on many tax committees for such organizations as Manufacturers Alliance, American Institute of Certified Public Accountants and the Semiconductor Industry Association, and he has testified on tax policy issues at the state and federal levels. A certified public accountant and attorney, Blaylock received his undergraduate degree from Baylor University and his law degree from Baylor Law School.

A.J. Brune III of Midland is chief financial officer and executive vice president of Wagner and Brown, Ltd., an independent oil and gas producer where he has worked since 1986. Brune is also a certified public accountant. He was recommended for appointment to the commission by House Speaker Tom Craddick. He previously held the position of vice president - taxation of Conquest Exploration Company, an American Stock Exchange-listed oil and gas exploration and production company. Brune

also worked for Arthur Andersen and Company for 12 years, eventually serving as a partner in the tax division of their Houston office. He received his bachelor's degree from the University of Houston.

T. Randall Cain of San Antonio, a certified public accountant, is managing partner of Ernst & Young's San Antonio office, where he also serves as the Gulf Coast area tax managing partner. A graduate of Texas A&M University where he received a bachelor's degree in business administration, Cain is a member of the American Institute of Certified Public Accountants, the Texas Society of Certified Public Accountants, and Texas A&M University Mays College Development Council. He also has served as treasurer of the San Antonio Economic Development Foundation, chairman of Junior Achievement of South Texas, and on the 12th Man Foundation and the Greater San Antonio Chamber of Commerce.

Alonzo Cantu of McAllen is president of Cantu Construction Co., which was awarded the National Minority Construction Firm of the Year. Cantu serves as chairman of the board for Lone Star National Bank and is involved in civic organizations including Court Appointed Special Advocates, Valley Initiative for Development and Advancement, United Way, and the National Congressional Hispanic Caucus Institute. He co-founded and is chairman emeritus of Valley Alliance of Mentors for Opportunities and Scholarships, which has raised more than \$8 million to provide scholarships for Hispanic students in the Rio Grande Valley. Cantu received a bachelor of business administration in finance from the University of Houston.

James D. Dannenbaum of Houston is chairman, president and chief executive officer of Dannenbaum Engineering Corporation. During his time with the company, he has served progressively as a design engineer, associate, executive vice president and in 1972, became president. Dannenbaum is a member of the American Society of Civil Engineers, the Consulting Engineers Council of Texas, Inc., and the Texas Society of Professional Engineers. He is a member of the UT M.D. Anderson Cancer Center Board of Visitors and the UT Houston Health Science Center Development Board. Dannenbaum is chairman of the Texas Cancer Council and is a member of The Chancellor's Council of The University of Texas System. He was selected as Engineer of the Year in 2004 by the Texas Society of Professional Engineers. Dannenbaum received a bachelor's degree in civil engineering from The University of Texas at Austin.

Printice L. Gary of Dallas is managing partner of Carleton Residential Properties, a position he has held since founding the firm in 1991. Before that, Gary was a division partner for Trammell Crow Residential Co. from 1986 to 1991, where he oversaw the acquisition, financing, development, construction, asset management, and property management of more than 6,000 multifamily housing units. From 1978 to 1985, he was vice president and corporate controller for Fox & Jacobs, Inc. He started his career as an investment banker with Piper Jaffray, and he also is a former division president with the Centex Corp. Gary is active in civic organizations, having served on the Dallas Citizens Council, Southwestern Medical Foundation and the North Texas Tollway Authority. He currently serves on the board of C.C. Young, Inc., a multiple service retirement organization in Texas, and the National Equity Fund, Inc. in Chicago, Illinois. He received a bachelor's degree in economics from Carleton College, where he currently serves as a trustee, and a MBA degree from Harvard University.

Wendy Lee Gramm of Helotes is a distinguished scholar and founder of the regulatory studies program at the Mercatus Center at George Mason University in Virginia. Gramm serves on the executive

committee of the Association of Private Enterprise Education and is on the board of the Texas Public Policy Foundation. She served as chairman of the U.S. Commodity Futures Trading commission for five years and was Administrator for Information and Regulatory Affairs at the Office of Management and Budget for three years. Gramm is also former executive director of the Presidential Task Force on Regulatory Relief and former director of the Federal Trade Commission's Bureau of Economics. She has been a member of the Board of Regents of the Texas A&M University System since 2001. A graduate of Wellesley College, Gramm received a doctorate degree in economics from Northwestern University.

Jodie L. Jiles of Houston has been in the municipal finance business for 20 years with various Wall Street, regional and minority firms. He currently serves as senior vice president with First Albany Capital and his responsibilities include coordinating municipal finance operations and implementing strategic marketing plans with targeted clients throughout the Southwest. Jiles is immediate past chairman of the Greater Houston Partnership. He also serves on the Board of Directors of The One Hundred Club, The Greater Houston Visitors and Convention Bureau and The Pyramid/CDC, and he is a director of the Houston Branch of the Federal Reserve Bank of Dallas. Jiles serves on a number of boards and commissions, including the Baylor College of Medicine Board of Directors, Texas Children's Hospital Board of Directors and the University of Texas Health Science Center Development Board. He also is a board member of the Center for Reform of School Systems, serves on the advisory board for KIPP Academy and a former member of Houston Independent School District Foundation. Jiles has also served as chairman of the Governor's Business Council Math Initiative and former vice chairman of the Reading Initiative for the Governor's Business Council. Jiles has a bachelor's degree in accounting from the Texas Southern University and a master's degree in professional accountancy from The University of Texas at Austin.

Hunter Hunt of Dallas is senior vice president of Hunt Oil Co., where he focuses on the company's liquefied natural gas efforts and other energy operations, including Hunt Power. He previously worked for Morgan Stanley in London and New York. He is vice chair on the economic steering committee of the Bill J. Priest Institute for Economic Development and a member of the executive board of the School of Engineering of Southern Methodist University (SMU). Hunt is a graduate of SMU, where he received his bachelor's degree in both economics and political science.

Woody L. Hunt of El Paso is chairman and chief executive officer of Hunt Building Company, Ltd., a privately owned development, construction and property management company. Hunt was previously vice chairman of the University of Texas System Board of Regents and currently serves as the vice chairman of its investment management company (UTIMCO). A member of the Governor's Business Council, Hunt serves on its Executive Committee and chairs the Higher Education Task Force. Hunt is president of the Hunt Family Foundation, which, along with other charitable endeavors, created the Public Policy Research Center and other university organizations at UT El Paso. In El Paso, he is involved in community organizations such as the Paso del Norte Group, where he chairs the Higher Education Committee.

Kenneth M. Jastrow, II of Austin is chairman and chief executive officer of Temple-Inland Inc., an Austin-based company, which he has been with for 27 years. Jastrow serves as director of MGIC Investment Corporation, KBHome and the American Forest and Paper Association. He is past chairman of Texas Taxpayers and Research Association and the Texas Mortgage Bankers Association. Jastrow is

past chairman of The University of Texas Development Board, advisory council of the McCombs School of Business, Neighborhood Longhorns and was Chairman of The Commission of 125. He is a member of Governor Perry's Business Council. Jastrow is a distinguished alumnus of UT and a member of the McCombs School of Business Hall of Fame. He received his bachelor's and master's degrees from The University of Texas at Austin.

Victor E. Leal of Canyon is a small-businessman and owner of Leal's Restaurants, a chain of four family restaurants, a business started by his parents in 1957. A former mayor of Muleshoe, he also has served as a regional vice president of the Texas Municipal League, on the Region 17 Service Center and as a director of the Muleshoe Chamber of Commerce. He has received a number of regional business awards, including the 1991 Business of the Year award from the Whitesboro Chamber of Commerce, the 1994 Business of the Year award from the Muleshoe Chamber of Commerce, and the 1996 Employer of the Year award from the Muleshoe Chamber of Commerce. He also is a member of the Texas Restaurant Association and National Federation of Independent Business (NFIB) and serves on the board of directors of the Amarillo Chamber of Commerce and on the United Way cabinet.

Judith A. Lindquist of San Antonio is general counsel and corporate secretary of H-E-B food and drug retailer. Lindquist was recently appointed to the Board of the Texas Taxpayers and Research Association. Previously, she was a managing director and member of the executive committee of Hewitt Associates; of counsel to Gray, Plant, Mooty, Mooty and Bennett, PA; and a partner of Fredrikson and Byron, PA. Lindquist currently serves on the Fredrikson's outside advisory board. She has served on the American Law Institute's Continuing Professional Education Advisory Group, has served as co-chair of the ABA National Conference on Executive and Employee Compensation and was a member of the Journal of Taxation of Employee Benefits Advisory Board. During her tenure as a practicing attorney, Lindquist was named in The Best Lawyers in America, published by Woodward White, Inc. A graduate of the University of Illinois, she received a law degree from the University of Chicago Law School.

William A. McMinn of Houston is currently involved in various aspects of nanotechnologies and biopharmaceutical industry. McMinn spent 34 years in the corporate world working for such companies as Petro-Tex Chemical Co. and FMC Corp. He was vice president of FMC and general manager of its Industrial Chemical Group in Philadelphia. McMinn served on the company boards of Cain Chemical, Arcadian Corp., Texas Petrochemicals and Lexicon Genetics. He was president and chief executive officer of Cain Chemical and chairman of Arcadian and Texas Petrochemicals. McMinn currently serves on the board of directors of Carbon Nanotechnologies, Rational Technology and Legend Ventures. He is also chairman of the board of the Texas Public Policy Foundation. McMinn received his bachelor's degree from Vanderbilt University in Nashville, Tenn.

Ernest A. Morales of Devine is co-owner and general manager of Morales Feedlots, Inc., a family-owned commercial cattle feeding and ranching business that he has worked for since his youth. Morales has served in different capacities in the Texas Cattle Feeders Association and served on the board of directors for both the Texas Beef Council and the National Cattlemen's Beef Association. He has also served as commissioner of the Texas Animal Health Commission and as a member of the Devine Independent School District board of trustees. Morales received a bachelor's degree in animal science from Texas A&M University.

Jan Newton of Austin is the recently-retired President of AT&T Texas. During her 30-year career, Newton held several positions including executive director in the office of SBC Chairman and CEO Ed Whitacre, and as executive director of wholesale policy and resale marketing. She was active in the Texas Taxpayers and Research Association, the Texas Telephone Association and the Roundtable Advisory Committee for TexasOne. She serves on the board of the Women's Museum in Dallas and has been active in chambers of commerce, the United Way, Junior Achievement, and Boy and Girl Scouts. A graduate of Texas Tech University, Newton completed post-graduate management programs at Duke University and the University of Southern California.

Dennis Patillo of Houston is chief executive officer of ERA Stephen Properties in Houston and president of Stewart Title in Victoria and chairman-elect of the Texas Association of Realtors. As a small-business owner, Patillo commits much of his time to legislative issues that affect the real estate industry. At the national level, Patillo served on the National Association of Realtors (NAR) board of directors as well as NAR's Multiple Listing Service, governmental affairs and business issues committees. Since 2002 he has served on NAR's Federal Tax Working Group, where he reviews in detail federal tax proposals as they relate to the real estate industry and recommends policy positions for NAR. Patillo is a national authority on real estate-related consumer trends, and taxation and legislative issues.

John V. Roach of Fort Worth is currently Chairman of the Board Emeritus of Tandy Corporation, which is now Radio Shack Corporation. Roach has worked in different capacities with the company since 1967, holding such positions as general manager of Tandy Computer Services, vice president of Radio Shack Manufacturing, and president and chief executive officer of Tandy Corporation. He serves as a board member on the Texas Christian University (TCU) Board of Visitors, the Scott and White Memorial Hospital and as chairman of the Fort Worth Executive Roundtable. Roach is a former board member of the Texas Department of Commerce, former chairman of the United Way and former president of Fort Worth Country Day School. He received a bachelor's degree in physics and math and later a master's degree from TCU.

Robert Rowling of Irving is the owner and chairman of TRT Holdings, Inc., a privately owned, diversified holding company that owns the Omni Hotels chain and Tana Exploration Co. Rowling serves as chairman of Omni Hotels. He is a member of the board of trustees of The University of Texas System, the board of directors of the Investment Management Company (UTIMCO) and chairs the Task Force on U.T. Dallas Lands. Rowling is also the past chairman of the Corpus Christi Area Economic Development Corp. He currently chairs SMU's Willis M. Tate Distinguished Lecture Series and serves on the national board of trustees for Young Life. In October 2003, Rowling was inducted into the Texas Business Hall of Fame, and he received the 2003 Distinguished Alumni Award from SMU's Dedman School of Law. A graduate of The University of Texas at Austin, Rowling received his law degree from SMU's Dedman School of Law.

Ronald G. Steinhart of Dallas is a private investor who serves as a Director of United Auto Group, Inc. and as a Trustee of MFS/Compass Group of Funds. Steinhart served as Chairman and Chief Executive for the Commercial Banking Group of Bank One Corp. from 1996 until his retirement in 2000. He also served as Chairman and CEO of Bank One Texas, a company he joined in connection with the merger of Bank One and Team Bank, which he founded in 1988. He also serves as Member of the United States

Holocaust Memorial Council, as a Director of the State Fair of Texas, Dallas Museum of Art,, and the Dallas Center for the Performing Arts, and as a Trustee of the Dallas Foundation, Temple Emanu-El Foundation and Dallas Medical Resource. He has a bachelor's degree in accounting and a MBA from The University of Texas at Austin and is a Certified Public Accountant. He also chaired The University of Texas at Austin Capital Campaign and is past Chairman of the university's Development Board.

Dr. David Teuscher of Beaumont is a partner and member of the board of directors of the Beaumont Bone & Joint Institute as well as the team orthopaedist for Lamar University's men's and women's NCAA teams. He is an orthopaedic surgeon at the Beaumont Bone and Joint Institute, Christus St. Elizabeth Hospital and Memorial Hermann Baptist Beaumont Hospital. Teuscher received his undergraduate degree from the University of Illinois at Urbana-Champaign and his doctor of medicine degree from The University of Texas Medical School at San Antonio. He did his post-graduate internship and residency at Brooke Army Medical Center. He is a diplomate of the American Board of Orthopaedic Surgery, a fellow of the American Academy of Orthopaedic Surgeons, managing editor of Orthopaedic Medical Legal Advisor, and previously served on the faculty of The University of Texas Medical Branch at Galveston, the University of Oklahoma School of Medicine and Baylor University. He also is the recipient of several military awards, including the Army Commendation Medal with Oak Leaf, the meritorious Service Medal, National Defense Service Medal and the Southwest Asia Campaign Ribbon with Oak Leaf.

Howard Wolf of Austin is chairman of the board of Stewart & Stevenson Services and acting chairman of the Falcon Seaboard Companies. Wolf, who was recommended for appointment to the commission by Lt. Gov. David Dewhurst, also is a member of the board of directors of Simmons & Co. International and a retired senior partner of the law firm of Fulbright & Jaworski, where he practiced law for more than 40 years. He is a graduate of The University of Texas at Austin, where he received a Bachelor of Business Administration degree and a law degree. While at UT, Wolf was elected president of Student Government and president of the Intrafraternity Council. While in law school, Wolf was elected to the Order of the Coif and was associate editor of The Texas Law Review. He also is currently serving a second two year term as a Public Member of the Texas Sunset Advisory Commission.

Staff of the Texas Tax Reform Commission:

Robert Howden, a former communications director for Governor Perry, is staff director for the commission. Before working for Governor Perry, Howden was the executive director of the National Federation of Independent Business (NFIB) in Texas for more than 10 years. While at NFIB/Texas, Howden worked with then Governor Bush to create the first-ever small business franchise tax exemption. He also worked with then-Lt. Governor Perry to create the Lt. Governor's Small Business Summits that were held in seven cities throughout Texas.

Karey Barton, former director of tax policy during the Comptroller Sharp administration, is tax director for the commission. Barton's tenure includes six years in private consulting and fourteen years with the Comptroller's office. As assistant manager of revenue estimating, he was the primary contact for legislative fiscal analysis issues for the Comptroller's office and oversaw the legislative fiscal note process within the agency for six years.

James LeBas, director of financial analysis for the commission, is the state's former chief revenue estimator and currently serves as chief financial officer for the Texas Water Development Board. His earlier work included budget and planning analysis for the Governor's Office, during which he helped develop and deliver Governor Bush's 1997 proposal for property tax relief. LeBas received his bachelor's and master's degrees in 1983 and 1985, respectively, from The University of Texas business school.



LEGAL AND ECONOMIC ENVIRONMENT

We now hold, as did the district court, that local ad valorem taxes have become a state property tax in violation of Article VIII, section 1-e, as we warned ten years ago they inevitably would, absent a change in course, which has not happened. ... To end the constitutional violation, we agree with the district court that the use of the current system must be enjoined.

— Supreme Court of Texas, November 22, 2005

The Supreme Court Ruling

On November 22, 2005, just one day after the Texas Tax Reform Commission convened its first meeting, the Texas Supreme Court found that the state's method of financing public schools violated the constitutional prohibition against a state property tax. The Court said, in effect, that the state cap on property tax rates and the state requirements to which school districts are held combine to eliminate meaningful discretion for school districts in setting their tax rates. In other words, if the state is setting both the floor (the education requirements) and the ceiling (the rate cap) in a way that forces most tax rates to the ceiling, then a *de facto* state property tax exists, prohibited under Article VIII of the state constitution.

The Court's decision is the most recent in more than two decades of near-continual public school finance litigation; of the various issues brought to the Court's attention, the plaintiffs prevailed only on the question of the state property tax. The state prevailed on matters related to the adequacy and efficiency of the system, leaving the financial aspects to be remedied no later than June 1, 2006. Practically speaking, the property tax must be lowered, the revenue replaced, and the schools given tax rate setting discretion to bring the system back into compliance with the court order.

The Supreme Court has given the Legislature a June 1, 2006 deadline to solve this problem. It was in this environment that the Tax Reform Commission began its work and under which the 79th Legislature must act.

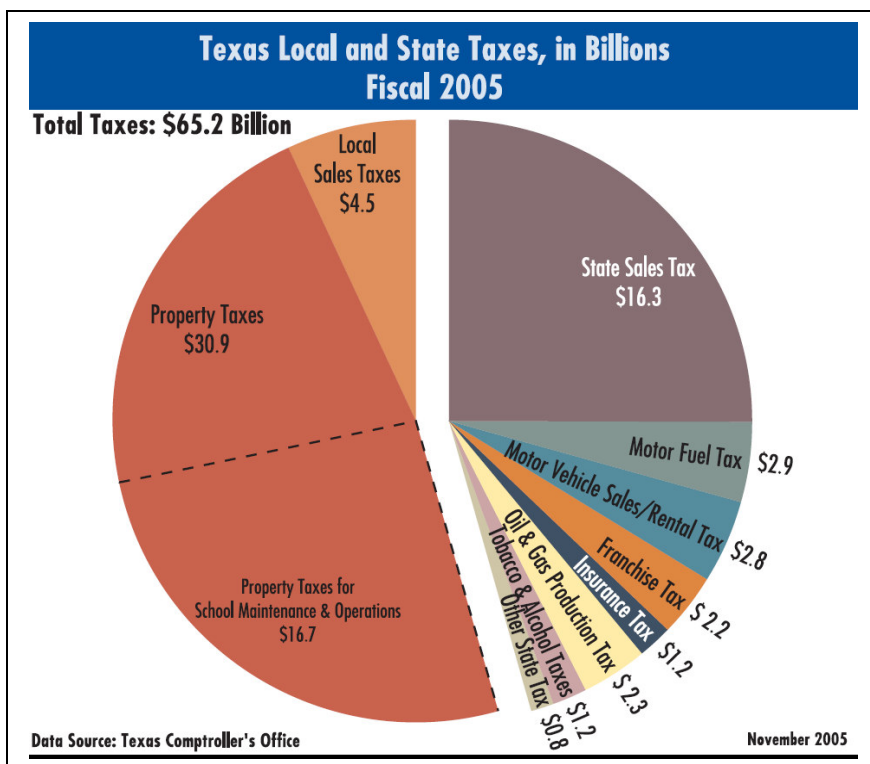
Why Texas Has Been Unable to Grow Its Way Out of the Problem

The fiscal and economic situation that the state faces is as challenging as the legal environment, to which two Regular Sessions and three Special Sessions of the Legislature can attest. Significant time, research, and efforts expended by the 78th and 79th Legislatures toward restructuring the tax system and public school finance have not yet borne fruit. And in fact the challenge goes back even further, as Comptroller Bob Bullock first observed two decades ago:

There are whole industries today—enormously important and profitable industries—that weren't even dreamed of twenty-five years ago. The new economy has been described by many names: service, information, space age, diversified. But our tax structure remains tied to the past, to hard products and assets attached to the ground.

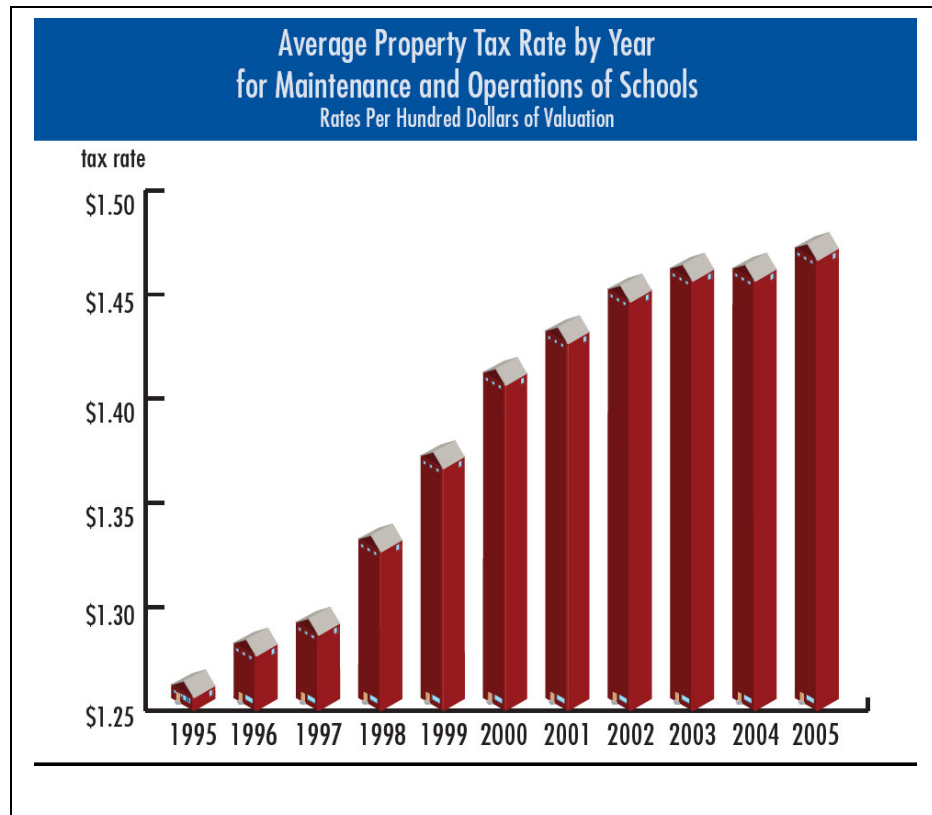
— Bob Bullock, *Time of Change/Time of Choice; Tax Equity and the Texas Economy*, 1986

The basic structure of today's Texas tax system is remarkably similar to that of twenty years ago, despite economic upheavals and numerous increases in existing taxes. At \$30.9 billion in fiscal 2005, property taxes imposed by local governments continue to dominate the tax landscape, dwarfing the state sales tax despite many rate and base increases in the sales tax since its adoption in 1961. The state sales tax generated \$16.3 billion in fiscal 2005, and local add-on sales taxes generated another \$4.5 billion. As different as they are, both sales and property taxes are levied primarily on tangible items despite an economy that is increasingly service-driven. Likewise, the state's taxes on motor fuels (gasoline), motor vehicles, and oil and gas production are duties on tangible products.



Over the past decade, property tax rates have risen steadily even as property values have increased. State aid to school districts has substantially increased from 1995 to the present, but could not on its own

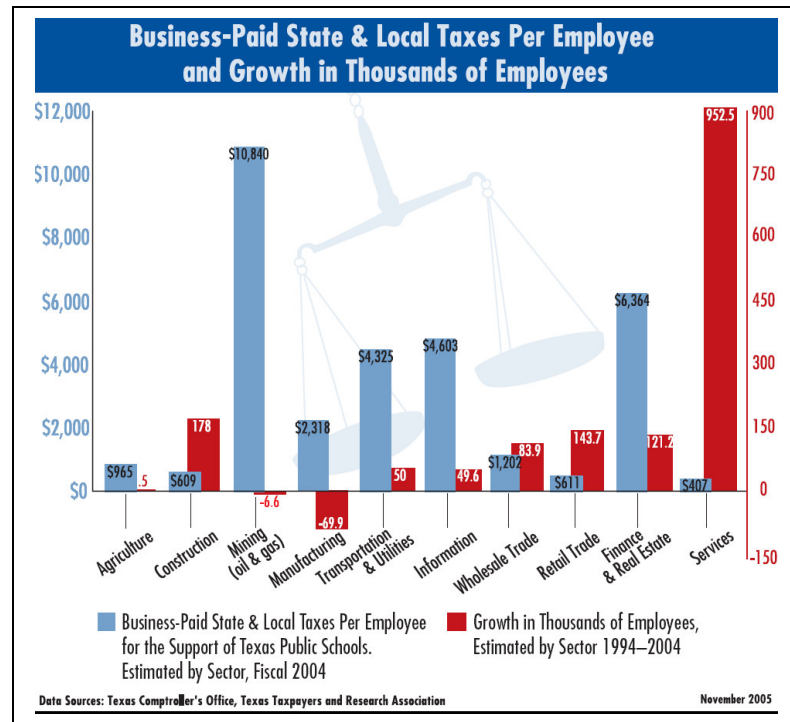
keep property tax rates down. The average property tax rate levied by school districts for “maintenance and operations” (for everything except debt repayment) has risen every single year, flattening out only in recent years as large numbers of districts have hit the tax rate cap of \$1.50 per \$100 of value. Rates have risen in part because under current law, long-



term growth in property values generates savings to the state rather than additional revenue to the school districts. Inflation, competition with the private sector for employees, and increased numbers of higher-cost students have also put upward pressure on school tax rates.

Another less visible but equally powerful force contributing to the rise in property taxes has been the inability of Texas’ archaic state-level tax system to maintain a state/local balance in the financing of education. As described by Comptroller Bullock in 1986 and affirmed by Governor Bush in 1996, the Texas tax system does not reflect the Texas economy. Most symbolic and symptomatic of this failing is the state’s business franchise tax. Of the major taxes that support the state’s general revenue fund – the largest portion of which is spent on education – the franchise tax had the lowest growth rate of all over the past decade. Growth rates in the bases of the sales tax, the property tax, and the motor vehicle sales tax all exceeded that of the franchise tax. Compare the growth rate in two other business taxes – the insurance companies tax at 99% growth and the oil and gas production tax at 164% growth – to the stunted 52% growth rate in franchise tax collections. This occurred while the Texas economy grew 72% over the same period.

Because of its antiquated structure, the impact of the Texas tax system on the various industries as it pertains to education funding is very uneven. During the past decade, the services sector of the Texas economy has grown substantially, adding nearly one million jobs but contributing about \$400 per job toward paying for schools. At the other extreme, the mining sector, primarily oil and gas, has lost more than 6,000 jobs but contributed almost \$11,000 per employee.¹ With the growth in the economy occurring in the lightly taxed industries, Texas cannot grow its way out of its tax problem. Rather, we're growing our way into it. Therefore, a broader base for the state's business tax is required, one that does not rely so heavily on property.



With the growth in the economy occurring in the lightly taxed industries, Texas cannot grow its way out of its tax problem. Rather, we're growing our way into it.

As we listened to people all over Texas, we found near-unanimous dissatisfaction from taxpayers about the level of property taxation. The other constant we heard from every corner of Texas is that property taxation is so high that it is the single largest barrier to economic development and job creation that Texas has. We ask businesses to expand and to locate or relocate here from other states, but when they see our high level of property taxation, they hesitate. We are many times able to recruit them only with massive abatements and incentive dollars. Our high level of property taxation is and will continue to be the largest job killer in Texas. This level of property taxation is not sustainable if we are to have a prosperous Texas in the future.

¹ This analysis displays the relationship between an industry's tax payments for the education system and its draw on that system (number of employees). An analysis of the relationship between tax payments and other measures, such as revenues or profitability, would produce a different distribution.



THE COMMISSION'S WORK

As you consider proposals to reform the Texas business tax structure, I ask that you judge each idea on its merits and whether it will achieve the primary goal of lowering property taxes and ensuring greater fairness across the system, and providing a long-term reliable source of revenue for our public schools. ... By agreeing to serve your fellow Texans, the people of this state, you seize a golden opportunity to make a lasting difference for future generations. And I know this group's going to succeed.

— Governor Perry's address to Tax Reform Commission, November 21, 2005

Hearings

The Commission met for the first time on November 21, 2005 in the Capitol. At this meeting, the Governor charged the Commission with designing a tax system to be based on five fundamental principles:

- Fairness – The tax system must provide a level playing field that is essential for healthy, free market competition.
- Broad Based – Those who benefit from Texas' resources and services must pay their share.
- Modern – The tax system must reflect the realities of a rapidly evolving economy.
- Understandable – Those considering locating or expanding business in Texas should know what their obligations will be. Small business owners must be able to focus their time and resources on creating jobs rather than navigating a maze of government regulations.
- Competitive – The tax system must allow Texas to attract jobs. Texas must be the most competitive state in the nation when it comes to building or moving a business here, risking capital, and winning in a global economy.

Invited testimony was taken from staff and from Drs. Steve Murdock and Ray Perryman, who armed the Commission with the essential facts on Texas taxation, economics, and demography.

Public testimony was taken at hearings across Texas beginning in December 2005 and concluding in March 2006 at which hundreds of witnesses addressed the Commission. Public witnesses ranged from business associations to school officials to Texas citizens.

<u>Date of Hearing</u>	<u>City</u>
December 13, 2005 (AM)	Victoria
December 13, 2005 (PM)	Corpus Christi
January 9, 2006	Austin
January 11, 2006	El Paso
January 18, 2006 (AM)	Belton
January 18, 2006 (PM)	Waco
January 23, 2006	Lubbock
January 26, 2006	Laredo
January 27, 2006	Weslaco
February 7, 2006	Texarkana
February 13, 2006	Abilene
February 21, 2006	Nacogdoches
February 28, 2006	Midland
March 6, 2006	San Antonio
March 8, 2006	Houston
March 13, 2006	Arlington

Passionate testimony was common, reflecting Texans' varying but deeply held beliefs about taxation and education. Common statements heard were:

- That property taxes are too high;
- That taxation should be broad and as low as possible;
- That schools should be a priority for state funding;
- And – perhaps most frequently of all – that property taxation makes it difficult to attract businesses to Texas without serious and costly incentives.

Conclusions

The Commission agrees with the four verdicts above voiced by the people of Texas. The school property tax must be brought down significantly. Replacement revenue must be from a broad-based, low-rate source. And the state budget must put school children first. We recognize that before a serious debate on school funding can occur, we must first address the Supreme Court's ruling, which we do with this report and accompanying legislation.

It is also the consensus of the Commission that school property taxes should not only be lowered, but should also remain as low as possible, while still recognizing the Texas Supreme Court's order to allow schools the required discretion. Some members of the leadership at the Capitol have stated that they should develop the mechanism to do that working with members of the legislature, appropriate persons from the education community and legal experts. While agreeing to that request, the Commission has also included in its proposed legislation a recommendation that the maximum tax rate be reduced from \$1.50 to \$1.30 at the time the school M&O (maintenance and operations) tax rate is lowered to \$1.00.



THE COMMISSION'S PLAN

High taxes, sometimes by diminishing the consumption of the taxed commodities, and sometimes by encouraging smuggling, frequently afford a smaller revenue to government than what might be drawn from more moderate taxes.

— Adam Smith, *The Wealth of Nations*, 1776

Property Tax Relief

The Texas Legislature, in both its 1997 and 1999 meetings, paid for property tax relief for the people of the state. In 1997, the state-mandated homestead exemption for school taxes was tripled from \$5,000 to \$15,000, for which the state replaced the revenue from its general fund. In 1999, this funding was continued, and the state paid for an additional 6¢-per-\$100 valuation property tax rate rollback. But in neither case did many Texans get actual tax reductions, as the added funding was absorbed and overwhelmed by other factors such as appraisal increases and subsequent rate increases.

It is the belief of the Commission that such minimal purchases of property tax relief, while occasionally affordable within the state's current revenue system, are too insignificant and fleeting to be meaningful. A meaningful reduction is one that brings the school tax² down to \$1-per-\$100 valuation for all school districts and keeps it down, subject to local control and a statutory hard cap of \$1.30 per \$100. Tax relief should be financed this tax year – 2006 – at a level that meets the Supreme Court's mandate for local tax rate discretion, using a mix of the existing state surplus and new revenues, including tobacco tax increases. Effective January 1, 2007, a new state tax system must be in place to finance the remainder of the property tax relief and to provide a permanent solution to the problem beginning with the 2007 tax year. Alternatively, the Legislature could finance the entire amount of property tax relief immediately by retroactively imposing the reformed franchise tax described in this report.

² This applies to the property tax levied by school districts for M&O (maintenance and operations) purposes, which excludes any tax levied to pay off bonds.

Financing Mechanisms

Franchise Tax Reform

The centerpiece of the Commission's financing plan is the broadening and lowering of the state's business tax, the franchise tax. For nearly a century the tax has been applied to corporations. The original purpose of the franchise tax – and that which the Commission finds is still valid – was to collect a modest levy in return for the tremendous value afforded to businesses that chose to benefit from a state-provided liability shield. However, the recent spread of new business forms such as limited-liability partnerships have tapped the state's protections previously available only to corporations while avoiding the very levy designed to reflect the value of that protection. Tax-free status has thus been secured by many firms, to the competitive detriment of those remaining in the corporate form.

Today the vast majority of businesses in the state escape the franchise tax, either through the deliberate use of tax-defeating organizational structures, or simply by avoiding the corporate form altogether. Many active businesses, some quite large, operate in Texas under a state-provided liability shield and compete with taxpaying companies while contributing nothing to franchise tax revenues.

These businesses, which may be formed as limited partnerships, limited-liability partnerships, professional associations, or business trusts, also benefit from the state's education system and would receive property tax relief under the Commission's plan. Many are organizations made up of professionals, the employees and owners of which were educated at great expense to the state. Hence they should be brought into the tax system in the same manner as are corporations. The clear intention of the law's original framers – that the franchise tax should be imposed in exchange for the state's liability shield – remains the guiding light for the Commission's recommendation.

In addition to broadening the forms of businesses that are subject to the franchise tax, the underlying base itself should be changed. Today, taxpayers pay on the *higher of* two tax bases: one reflecting net income, the other net worth. Neither of those two components are a broad and stable measure of a business' activity in Texas: net income is a relatively small tax base that fluctuates dramatically with business conditions and which requires a high tax rate, and net worth is not a measure of activity at all.³ Designing a broad and stable tax base that encourages job creation and investment was the Commission's goal.

³ The state's ability to impose a net income tax on non-corporate entities may also be impaired by an existing Constitutional provision.

Our solution is to re-base the franchise tax on a business' margin – rather than net income or net worth – and to slash the primary rate from 4.5% down to 1%.⁴ In computing its margin, a business would pay on the *lower of* two calculations: deducting either cost of goods sold,⁵ or employee compensation (including health insurance and other benefits),⁶ from its total revenue.⁷

Compared to previous franchise tax reform proposals, employers would be rewarded, not punished, for hiring people and for providing health care and pensions, as all three would lower their tax.

Because the reformed franchise tax would continue to be levied in exchange for state-provided liability protection, sole proprietorships and general partnerships owned by natural persons would remain exempt, as would non-profit

organizations. The tax would apply only to active businesses, exempting passive unincorporated investment pools so that double taxation is avoided and the state's ability to attract investment capital is maintained. Additionally, the current franchise tax exemption for small, liability-protected businesses with less than \$150,000 in total revenue would be doubled to \$300,000 and increased over time with inflation.

Consumption Taxes

Consumption taxes would also be used to finance property tax relief. The state's tobacco taxes, long unadjusted, would be increased. The cigarette tax would be increased by \$1.00 per pack, and taxes on other tobacco products would be increased 13.6%.

Two anti-fraud measures would also boost state tax collections. Increasing the Comptroller's audit and enforcement activities would improve compliance and revenue, and replacing the so-

Reformed Franchise Tax Based on Margin	
<i>SAMPLE -- company with all its revenue from Texas sales</i>	
Total Revenue	\$1,000,000
Deduct Choice of Either:	
Cost of Goods Sold	300,000
or	
<input checked="" type="checkbox"/> Employee and Owners Compensation	600,000
Equals Margin	\$400,000
Tax Rate:	1%
Tax:	\$4,000

Tax BEFORE Property Tax Savings

⁴ Trade businesses (those engaged primarily in wholesale or retail activities) would pay 0.5%, in recognition of the low profit margins that are basic to the industry.

⁵ Cost of goods sold would be computed in a manner similar to the method for federal income tax purposes. Lending institutions would use interest expense as their cost of goods sold.

⁶ All employee and owner benefits, such as expenses for retirement and health insurance, would be deductible as compensation. Cash compensation would also be deductible for payments and distributions of up to \$300,000 for any employee or owner, increased over time with inflation.

⁷ Multi-state businesses would compute their Texas portion of the margin using the same calculation currently used for the franchise tax.

called used car “liar’s affidavit” form with a system based on standard vehicle value would increase motor vehicle sales tax revenues.

Making Education the Top Priority in the State Budget

The third major element of financing property tax relief would come from the state surplus and natural increases in future state revenue. In so doing, the state acknowledges that education is our top budget priority, and that a significant share of general revenue available today, and of the growth of tomorrow’s revenue, should go first to education and to the inextricably-linked property tax system before other budget demands are considered.

Long-term Funding for Public Schools

Ensuring that the state maintains its share of the cost of education will be a major long-term factor in keeping property tax rates down. The Commission encourages the 79th and all future Legislatures to continue funding for the tax relief provided by the Commission’s plan, and supports additional amounts as may be afforded by natural growth in state revenues in the future.



EXAMPLE TAX FORMS

Schedule A: School Maintenance and Operations Taxes

	Current Law		Proposed Law	
	Tax Rate (per \$100)	Calculation	Tax Rate (per \$100)	Calculation
School Property Tax Relief				
1	1			
2	2		\$1.00	
3	3	-		0.010
4	4	\$ -		\$ -

Notes for each line:

- ¹ Taxable value of property will be the same under current and proposed law.
- ² The current weighted average statewide school maintenance and operations tax rate is \$1.48. Actual current law tax rates for each individual taxpayer may be different. Proposed law would reduce all districts to a tax rate of \$1.00.
- ³ Property tax rates are commonly expressed in terms of taxes per \$100 of valuation. To convert this to a percentage tax rate, divide the tax rate expressed in dollars by 100.

Schedule B: Reformed Franchise Tax Calculation

Line and Item	Amount	Amount
<i>Form to be filed and taxes paid on a water's edge unitary combined basis.</i>		
<i>(See instructions for more detail on each line item)</i>		
1. Total Revenue (if \$300,000 or less, enter "0" on lines 7 and 9).....		
2. Less Certain Deductible Expenses		
a. "Cash" compensation, such as wages, salaries, stock options, not to exceed \$300,000 for any single employee.....		
b. Employer's Cost of Retirement Contributions.....		
c. Employer's Cost of Employee Health Insurance.....		
d. Employer's Cost of Workers' Compensation		
e. Employee Compensation (sum of <i>a</i> through <i>d</i> above).....	-	
f. Cost of Goods Sold (similar to federal tax return)		
g. Enter greater of line <i>e</i> or line <i>f</i>		
3. Margin (line 1 minus line 2g, but nte 70% of line 1).....		
4. Texas Apportionment (same as current franchise tax)		
a. Gross Receipts Everywhere.....		
b. Texas Gross Receipts.....		
c. Percentage of Gross Receipts Attributable to Texas (line 4b divided by line 4a).....		
5. Taxable Margin (line 3 multiplied by line 4c).....		
6. Tax Rate (wholesalers & retailers, 0.5%; all others, 1%)		
7. Tax (line 5 multiplied by line 6)		
8. Less Prior Credits Earned		
9. Tax Due (line 7 minus line 8 but not less than zero)		

Summary of Tax Reform Plan

Item		Current Law	Proposed Law		Difference
		Amount	Amount	Explanation of changes	Amount
Property Taxes					
1	a. School Maintenance & Operation (enter amounts from Schedule A)			Reduction of Tax Rate (See Schedule A)	\$ -
	b. School Debt Service			No change; current law amount for both boxes	-
Business Tax					
2	Franchise Tax			Current law franchise tax, Reformed Franchise Tax from Schedule B under Proposed Law	-
Tobacco Taxes					
3	a. Cigarette Tax			Increase from \$0.41 rate to \$1.41 tax rate	-
	b. Other tobacco products			Multiply current law by 1.136 (13.6% increase)	-
Total Taxes, sum of lines 1-3		\$ -	\$ -		\$ -

Schedule B Instructions Reformed Franchise Tax Calculation*

Exemptions: The following businesses are exempt from the tax:

- sole proprietorships;
- general partnerships (excluding limited liability partnerships) owned entirely by natural persons;
- passive unincorporated investment entities, where at least 90% of revenue is from passive investments (rent is not considered passive income);
- non-profit and other organizations currently exempt from the franchise tax;
- businesses with \$300,000 or less in total revenue; and
- businesses that owe less than \$1,000 in tax.

Combined Reporting Required: Affiliated groups of businesses must report on a water's edge unitary combined basis. An affiliated group includes all businesses in which a controlling interest (i.e. it is 80% or more owned) is owned by a common owner. The combined group is considered a single taxable entity and must elect the same deduction from total revenue.

Line 1—Total Revenue

For corporations, total revenue equals line 1c plus lines 4-10 on IRS Form 1120. For partnerships, total revenue equals line 1c plus lines 4-7 on IRS Form 1065, plus lines 3a and 5-11 on IRS Form 1065, Schedule K, plus line 17 on IRS Form 8825. Certain exclusions from total revenue are allowed such as for bad debt, foreign royalties and dividends, and net distributive income from entities treated as partnerships for federal income tax purposes. Additionally, certain types of "flow-through" funds that are mandated to be distributed to other entities may be excluded. A combined group can exclude from total revenue intercompany receipts from a group member.

Line 2a—Cash Compensation Deduction

This deduction is capped at \$300,000 per employee and includes wages, salaries, stock options, and net distributive income from entities treated as partnerships for federal income tax purposes, but only if the person receiving the distribution is a natural person. A combined group would exclude from cash compensation and benefits deductions any expense payments related to the intercompany receipts excluded from total revenue.

Lines 2b-d—Employee Benefits Deduction

This deduction is not capped and includes the cost of benefits the taxable entity provides, including retirement, health care, and workers' compensation, to the extent deductible for federal income tax purposes.

Line 2f—Cost of Goods Sold Deduction

This deduction is for taxable entities in the business of producing or selling goods and is generally computed in a manner similar to that used for federal income tax purposes. The term "goods" is generally defined as real or tangible personal property owned by and sold by the taxable entity and does not include services sold. If the taxable entity is a regulated lending institution, the cost of goods sold is equal to interest expense. A combined group would exclude from cost of goods sold deduction any expense payments related to the intercompany receipts excluded from total revenue.

Line 3—Margin

Margin equals total revenue in line 1 minus a deduction of the greater of compensation in line 2e or cost of goods sold in line 2f. The maximum margin in line 3 would be 70% of total revenue in line 1.

Lines 4a-b—Texas Apportionment Calculation

The apportionment calculation for business done in Texas based on gross receipts is the same as the current franchise tax. Receipts that are excluded from total revenue in line 1 may not be included in gross receipts (both for entire business and Texas) used for apportionment.

Line 6—Tax Rate

The tax rate applied to taxable margin is 1%, except the tax rate for taxable entities primarily engaged in wholesale or retail trade is 0.5%. A taxable entity is considered to be primarily engaged in wholesale or retail trade if the total revenue from these activities is greater than the total revenue from other activities. A taxable entity that predominantly sells or resells products that it or a member of the affiliated group produces would not qualify. Retail or wholesale utilities, including telecommunications services, electricity, or gas also would not qualify.

Line 8—Tax Credits

The franchise tax credits in current law are repealed. However, taxable entities with unused prior credits may continue to apply those credits for a certain period of time depending on the type of credit.

* Reflects changes made in HB 3 and HCR 51, 79th Legislature, 3rd Called Session, 2006.