



TTARA

Webcast Update

on Tax & Fiscal Issues

June 9, 2016

Continuing Education Credits

We are pleased to offer 1 hour of continuing education credit for attorneys, accountants, and professionals in taxation with the State Bar of Texas, the Texas State Board of Public Accountancy, and the Institute for Professionals in Taxation.

Certificates of participation have been uploaded and can be found on the Gotowebinar toolbar on the right side of your screen under the “Handout” menu. You can download and place a copy in your files. If you have trouble locating the certificate, contact Ryan at ryan@ttara.org and he will send you a copy. We will enter the State Bar of Texas credit, but accountants and tax professionals need to submit their credit to those organizations.



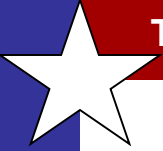
Agenda

1. Upcoming TTARA events
2. Fiscal Update and Outlook (a tough session ahead)
3. School Finance (assessing the court's decision)
4. Sales Tax (the saga of compressors and the manufacturing exemption continues)
5. Property Tax (updates on heavy equipment and truth in taxation)
6. Franchise Tax (wholesaler/retailer rules proposal)

Upcoming Meetings & Events

- **Annual Meeting:** Thursday, October 6 and Friday October 7 at the Sheraton Austin Hotel at the Capitol.
- **Webcasts:** September 9, and November 4. (All webcasts will start at 9:30 a.m. and last no longer than an hour).

All data and information is the property of TTARA and we ask that in sharing this data you credit TTARA with the source of information.



Fiscal Update

Current Budget Status, 2016-17

- Official state projections estimate an unspent balance of \$4.1 billion in general revenues
- The trend in revenue collections are below the official forecast, but within a certain margin of error
- Medicaid will likely require a supplemental appropriation near \$1 billion of general revenue

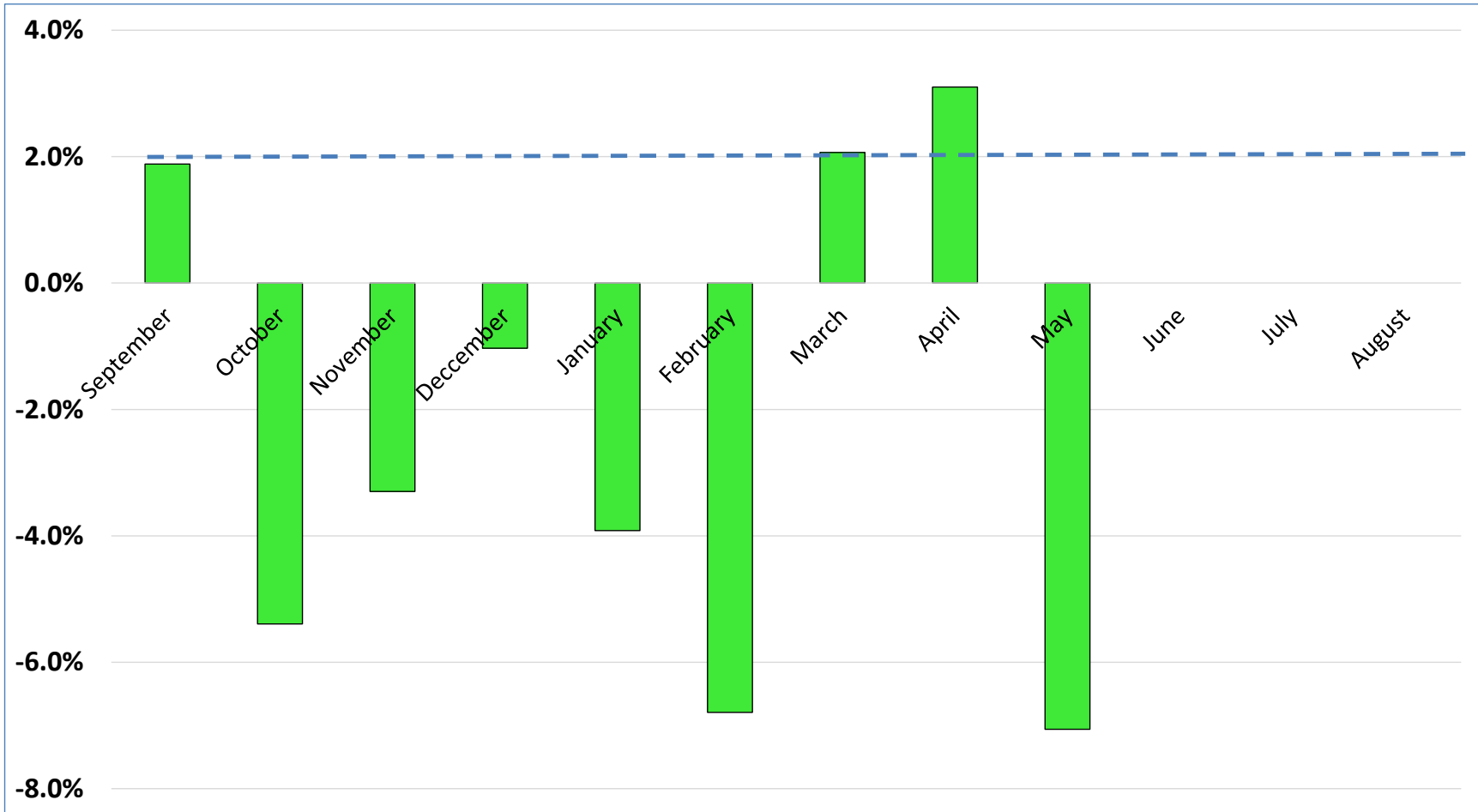
State Revenue Tracking

Through the End of May 2016

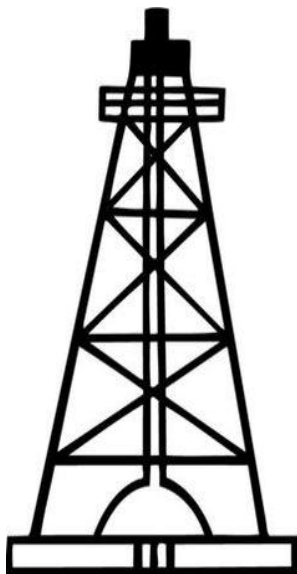
	2016 Projected Revenues	Projected Growth Rate	Actual Growth thru 9 Months
Sales Tax	\$ 29.1 b	1.2 %	(2.5 %)
Motor Vehicle Sales Tax	\$ 4.8 b	2.3 %	1.7 %
Severance Taxes	\$ 2.7 b	(49.1 %)	(50.2%)
Other Taxes	\$ 10.3 b	(9.9 %)	1.2 %
Non Tax Revenue	<u>\$ 6.3 b</u>	(2.3 %)	4.4 %
Total	\$ 53.3 b	(3.8 %)	(6.2 %)

Monthly Sales Tax Growth, FY 2016

Percent Change from the Same Month in the Prior Year

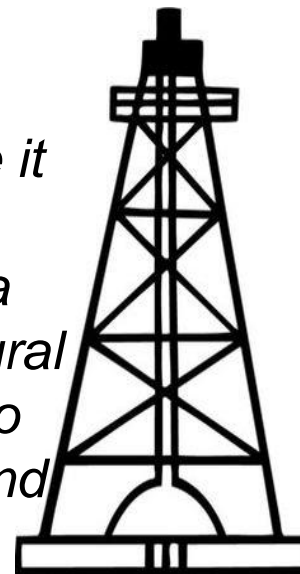


Tax Implications: Oil or Natural Gas



Oil Well

Reclassifying the well as a “natural gas” well may make it eligible for the high cost gas exemption, which provides a reduced tax rate on the natural gas, allowing the producer to apply for a tax credit or refund

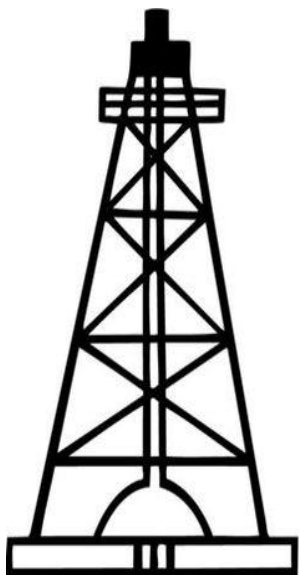


Natural Gas Well

Oil & Condensate	4.6%
Natural Gas	7.5%

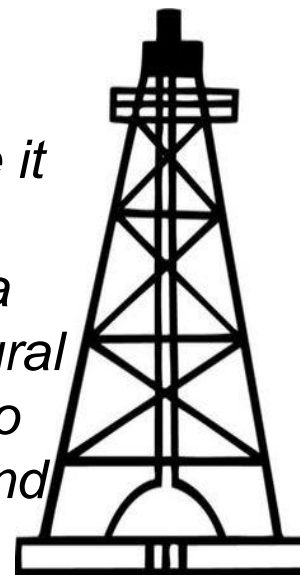
Oil & Condensate	4.6%
Natural Gas	~ 2.0%

Tax Implications: Oil or Natural Gas



Oil Well

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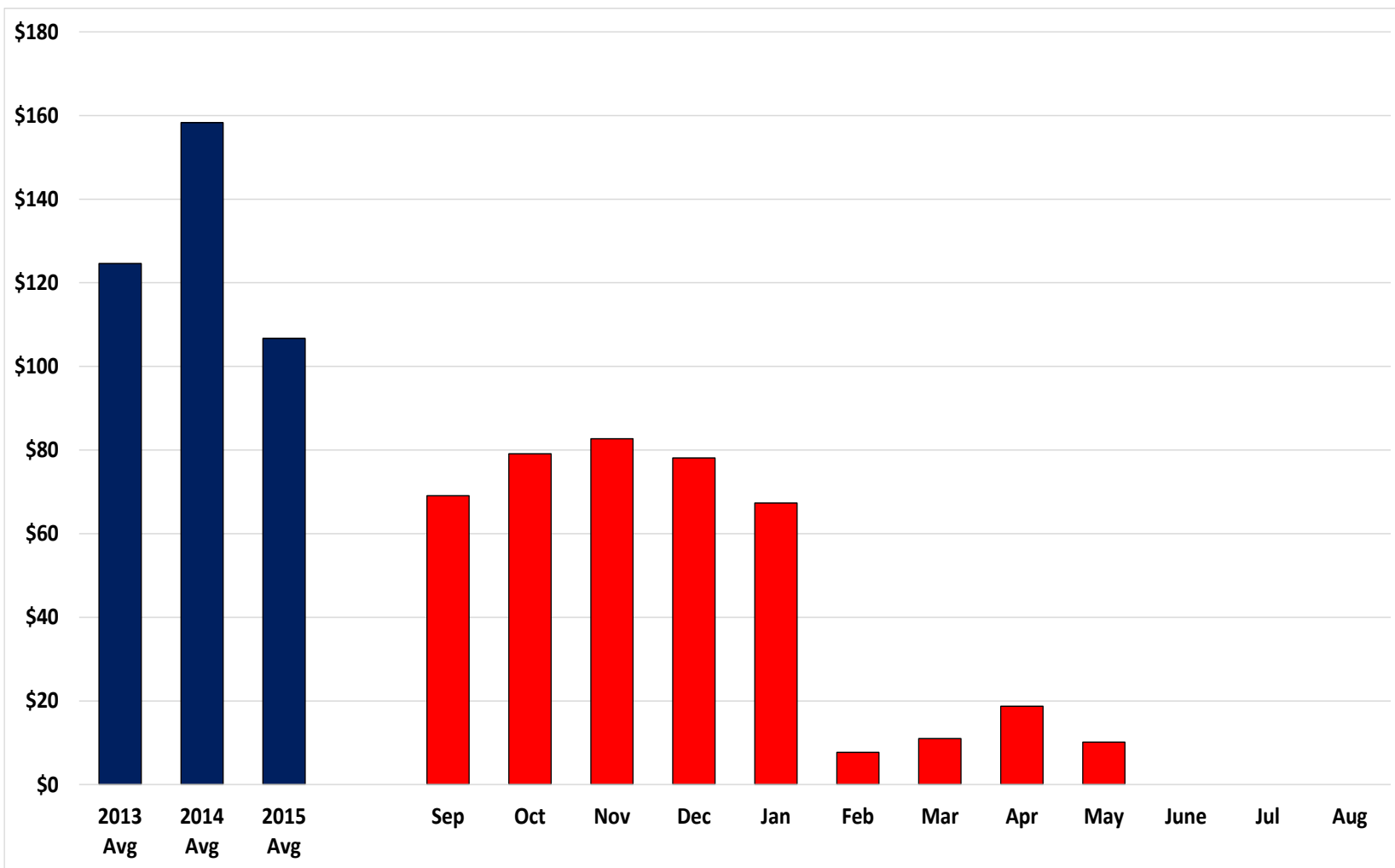
Natural Gas Well

Oil & Condensate 4.6%
Natural Gas 7.5%

Oil & Condensate 4.6%
Natural Gas ~ 2.0%

Monthly Natural Gas Tax Revenues

Monthly Averages 2013-15; Actual Monthly Collections 2016



2017: A Tough Session Ahead?

Dollars are in Billions

	<u>2016-17</u>	<u>2018-19</u>	<u>Difference</u>
Beginning Balance	\$8.3	\$4.1	(\$4.2)
Highway Dedication	\$0.0	\$5.0	(\$5.0)
Average "Growth"			~ \$5.0 - 6.0



Ordinary and Extraordinary Budget Items, 2017

Ordinary (Traditional) Items

Public Education (less if prop. values grow)~	\$2.4 billion
Medicaid (w/o ACA expansion)	~ \$3.0 billion
Employee Benefits	~ \$1.0 billion

Extraordinary Items

Retired Teacher Health Insurance	~ \$1.6 billion
Child Protective Services/Foster Care	~ \$0.5 billion
Southwest Royalties (court decision) AMC v. Hegar	



The Outlook for 2018-19

(i.e. the 2017 Legislature)

- The state may have less money available than it did in 2015 (although it didn't spend all it had then)
- The state may face a handful of extraordinary items on both the spending and revenue side
- With \$10 billion in the Rainy Day Fund, the big political fight will be over the amount of budget cuts versus using the Rainy Day Fund.
- There will not be a major tax increase, but there may be a number of “corrective bills” that “close loopholes”

School Finance

Texas Supreme Court Decision

May 13, 2016



Supreme Court ruled **in favor of the state** on all claims against the school finance system in a **unanimous decision** on May 13, 2016 written by Justice Willet.



Court said even though the system is **flawed**, it **meets all requirements of the Texas Constitution**.

Texas Supreme Court Decision (cont.)

May 13, 2016

Justices used the following terms to describe the school finance system:

Term	Definition
Recondite	Little known or obscure; difficult to understand
Byzantine	Intricately involved
Daedalean	Skillful, artistic, intricate, adorned by many things
Sclerotic	Grown rigid or unresponsive
Ossified	To become hardened or conventional and opposed to change

Texas Supreme Court Decision (cont.)

May 13, 2016

Justices also said:



The school children of Texas deserve transformational, **top-to-bottom reforms.**



It is up to the citizens to **elect legislators** who will implement the policy choices they desire.

Texas Supreme Court Decision (cont.)

May 13, 2016

Future Lawsuits



Court is sending a message to future plaintiffs to **seek remedy with the Legislature, not the courts.**



Unless the Legislature makes choices that are arbitrary and unreasonable, the Supreme Court will defer to the Legislature.

Texas Supreme Court Decision (cont.)

May 13, 2016

Adequacy – Overturned Judge Dietz



Court said more **money doesn't guarantee** better schools or better educated students.



Adequacy should be judged based on results rather than the amount of money in the system.



Plaintiffs focused on “more money” **without showing a link** to better school and student results.

Texas Supreme Court Decision (cont.)

May 13, 2016

Adequacy (cont.)

Court pointed out:



95% of schools and **87%** of campuses achieved the “**Met Standard**” designation



Texas’ graduation rate is **2nd** in the nation



NAEP Results for 4th and 8th grade

African American 4th in the nation

Hispanic 7th in the nation

Econ Disadv 11th in the nation

Texas Supreme Court Decision (cont.)

May 13, 2016

Adequacy (cont.)



Court **refused to rule on MALDEF's claims** that economically disadvantaged students and English Language Learners' performance on tests is inferior to other groups, and therefore schools should receive more money for those students.



Stated it was their job to look at the **whole education system** rather than **sub-groups**.

Texas Supreme Court Decision (cont.)

May 13, 2016

Equity – Overturned Judge Dietz



Court found that the **current disparity** in the amount of money available to property wealthy districts and property poor districts **falls within an acceptable range** deemed to be constitutional in previous decisions.

Ratio Between Property Wealthy and Property Poor Districts

	Edgewood I Unconstitutional	Edgewood IV Constitutional	Fairness Coal. Constitutional
Spending per WADA	2.4-1	1.17-1	1.07-1
Tax Rate	1.6-1	1.07-1	1.06-1

Texas Supreme Court Decision (cont.)

May 13, 2016

State Property Tax – Overturned Judge Dietz



Court said the system is **NOT a state property tax** because all of the school districts taxing at \$1.17 **offer enrichment programs** which shows they have “**meaningful discretion**” over their spending, and therefore over their tax rates.

Texas Supreme Court Decision (cont.)

May 13, 2016

State Property Tax (cont.)



Court rejected the claim that requiring a **tax ratification election** to adopt a rate **above \$1.04** denies them “meaningful discretion” and went on to say that they agree with the state that **letting local voters decide whether to raise taxes is the exact opposite of a state-imposed property tax rate.**

Texas Supreme Court Decision (cont.)

May 13, 2016

Efficiency Intervenors & Charter Schools



Court upheld Judge Dietz' decision to **dismiss** the claims of the Efficiency Intervenors and Charter Schools and **referred those groups to the Legislature for remedy.**

Texas Supreme Court Decision (cont.)

May 13, 2016

Remand for Attorney Fees



Judge Dietz had ruled that Plaintiff attorneys should receive attorney fees even if they lost the case because **“they have made significant contributions to the public debate on school finance law.”**



The Supreme Court **remanded the issue of attorney fees back to District Court** at the request of the state because the prevailing party changed.

Texas Supreme Court Decision (cont.)

May 13, 2016



No injunction deadline, so Legislature can address school finance if they wish, but it is not necessary



No statewide property tax, so it is not necessary to repeal or increase the M&O rate cap or buy down rates



System is equitable and adequate, so it is not necessary to increase funding

New Interim Charges to House Public Education and Appropriations Committees

6/2/16

- **“Current law requires the elimination on September 1, 2017, of Additional State Aid for Tax Relief (ASATR), which was intended to offset the cost of tax-rate compressions enacted in 2006. Review how this loss of funding would impact school districts.”**

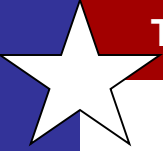
New Interim Charges to House Public Education and Appropriations Committees

6/2/16

- “Study the use of local property taxes to fund public education and its effects on educational quality and on Texas taxpayers. **Specifically, recommend ways to reverse the increasing reliance on recapture payments** to fund public education statewide.”
 - **Houston ISD: \$175 million** to be recaptured in 2017
 - **Austin ISD: \$400 million** to be recaptured in 2017(~ **\$4 billion per year** to get Houston out of recapture)

Existing Interim Charges to House Public Education and Appropriations Committees

- Examine the effectiveness and efficiency of the **Cost of Education Index (CEI)**.
- Evaluate the current state of school district **facility needs** and debt particularly for **fast growth districts**.
- Conduct a review of current **public education programs** administered by the Texas Education Agency that are funded **outside of the Foundation School Program**.



Sales Tax



Southwest Royalties v. Hegar **(Case #14-0743)**

Issue: Does downhole equipment used to extract oil and gas qualify for sales tax exemption as property used in manufacturing? Does such equipment, especially the pipe, directly make or cause a chemical or physical change?

- District Court ruled against taxpayer – April 2012
- 3rd Court of Appeals affirmed ruling that taxpayer did not meet burden of proof to show Comptroller's statutory interpretation was unreasonable – August 2014
- Supreme Court Oral Argument – 3/8/16
- Perryman Group Study for TAB – 6/7/16
(<http://web.txbiz.org/news/newsarticledisplay.aspx?ArticleID=1100>)
 - \$2.4 B in tax refunds – about half of Comptroller's estimate
 - Resulting boost in exploration activity within five years would result in state and local tax gains that would “substantially outweigh” the short-term impact on state coffers
 - Had exemption been effective since 2001, result would have been a \$36.7 B gain in gross state product over the 16-year period



O&G Compressor Taxability

- March 15, 2016 – Audit division memo to all audit personnel concerning gas compressors
 - Exempt
 - Boost pressure for sales purposes
 - Connected to multiple pieces of equipment that do more than extract water
 - Taxable
 - Stand-alone – no other equipment in immediate vicinity
 - Used to enhance production
 - Connected to dehydrator or other equipment that removes water or condensation



O&G Compressor Taxability

- June 1 Revision
 - Taxpayers will be given opportunity to provide evidence on the purpose and location of each compressor and other equipment and to calculate divergent use if the compressor performs both an exempt processing and a non-exempt transportation function
 - Compressors that support equipment that removes water or condensation for the purpose of transporting the gas will be considered taxable
 - Not a statement of agency policy but procedural guidance to improve audit consistency in certain common situations
 - If there is uncertainty, the case along with any evidence produced by the taxpayer is to be submitted to Audit Division's upper management for a final determination
 - TTARA will host a conference call this afternoon at 2:00 p.m. to discuss the compressor taxability issue. Contact ryan@ttara.org if you would like to participate



Property Tax



Constitutionality of Heavy Equipment Valuation Tax Code §23.1241

- Pending Cases in Supreme Court
 - *Reeves and Loving County CADs v. MidCon Compression* (Case #15-0969)
 - *Reeves and Loving County CADs v. Valerus Compression* (Case #15-0970)
 - *Loving County CAD v. EXLP and EES Leasing* (Case #15-0971)
 - *Ward County CAD v. EXLP and EES Leasing* (Case #15-0965)
 - District Court held valuation methodology unconstitutional as applied and determined situs to be in county where compressors were in use
 - 8th Court of Appeals reversed unconstitutional valuation ruling and upheld situs determination
 - Appraisal districts did not meet burden of proof on valuation issue and the legislature has discretionary authority to enact a special valuation methodology for heavy equipment inventory
 - Failed to demonstrate Legislature intended to fix situs at business location where equipment was rented

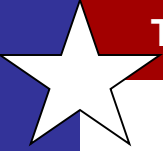


Constitutionality of Heavy Equipment Valuation Tax Code §23.1241

- *EXLP and EES Leasing v. Galveston CAD (Case #15-0683)*
 - District Court held valuation methodology unconstitutional as applied and determined situs to be in county where compressors were in use
 - 14th Court of Appeals upheld situs ruling but reversed & remanded constitutionality issue to District Court because evidence was not presented to conclusively resolve valuation issue
 - EXLP petition for Supreme Court review objected to remand
 - Attorney General Paxton filed *Amicus Brief* for the State supporting EXLP review petition and asserting that a statute is presumed constitutional and that constitutional reasonableness is a question of law and not of fact to be determined by a jury

“Truth-in-Taxation”

- How it works: When property values go \uparrow tax rate goes \downarrow
- If: Property values go \uparrow and tax rate goes \uparrow ...
BEWARE!



Franchise Tax

Franchise Tax

Who is a Wholesaler/Retailer

171.002 (c) A taxable entity is primarily engaged in retail or wholesale trade only if:

1. its total revenue from retail or wholesale trade is greater than the total revenue from trades other than the retail and wholesale trades;
2. except [for restaurants], less than 50 percent of its total revenue in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs; and
3. the taxable entity does not provide retail or wholesale utilities, including telecommunications services, electricity, or gas.



Wholesaler/Retailer Why Does it Matter?

Under current Texas law, a wholesaler/retailer qualifies for half the rate of other taxpayers.

Franchise Tax Rule Redraft

3.584 Margin: Reports and Payments

Proposed Rules Provision	Current Agency Policy
<p><i>A taxable entity produces the product that it sells if the taxable entity acquires the product and makes modifications to the product that increase the sales price of the product by more than 10%.</i></p>	<p><i>A product is not considered to be produced if modifications made to the acquired product do not increase its sales price by more than 10%</i> Current Rule 3.584(d)(3)(b)</p>
<p><i>A taxable entity produces the product that it sells if the taxable entity manufactures, develops, or creates tangible personal property that is incorporated into, installed in, or becomes a component part of the product that it sells.</i></p>	<p><i>A taxable entity will be considered the producer [and not a wholesaler/retailer] of the products it sells if the taxable entity ... produces a component part of the product</i> STAR 201503580L</p>

TTARA Comments on 3.584

- TTARA asks that the proposed rule be amended to allow a wholesaler/retailer to incorporate component parts they make into the final product provided they increase the sales price of the final product by no more than 10 percent.
- This would “match” the provision allowing a wholesaler/retailer to modify a product provided it does not increase the sales price by more than 10 percent.
- TTARA requested a roundtable meeting with taxpayers and the Comptroller to review and discuss.



3.584 Timeline

March 22, 2016	Comptroller circulates draft rule for informal review
April 12, 2016	After review, TTARA files comment & asks for discussion roundtable
May 5, 2016	Proposed Rule Filed with the Secretary of State
June 3, 2016	Comptroller informs TTARA they will host a roundtable after the formal comment period ends
June 19, 2016	Comment period ends, agency may adopt rule

Research & Development

HB 800 from 2013

Taxpayers given a choice of either:

- Sales tax exemption for purchases of R&D equipment, or
- Franchise tax credit of 5.0% for increased spending on R&D (6.25% if company contracts with an institution of higher education).



Comptroller Report

- Comptroller is required to report to the Legislature on the effectiveness of the credit/exemption:
 - Number of entities claiming credit or exemption
 - Amount of credits
- Comptroller is required to engage an independent researcher at an institution of higher education to assess the effect of the credit/exemption on:
 - R&D spending in Texas,
 - R&D employment in Texas,
 - Economic activity in Texas, and
 - State tax revenues.
- Independent research report is to be provided to each legislature **beginning in 2017.**



Thanks for Joining Us!

If you have any questions or comments, please feel free to contact TTARA staff.

Franchise Tax & State Budget: Dale Craymer	<u>dcraymer@ttara.org</u>
Sales & Property Tax: John Kennedy	<u>jkennedy@ttara.org</u>
School Finance: Sheryl Pace	<u>space@ttara.org</u>
Property Tax: George Christian	<u>gchristian@ttara.org</u>
Communications: Ryan Ash	<u>ryan@ttara.org</u>
Office Manager: Betty Wranischar	<u>bwranschar@ttara.org</u>
Membership: Nancy Shields	<u>nshields@ttara.org</u>

(512) 472-8838