Chapter 313: Why It Is Needed and How It Works

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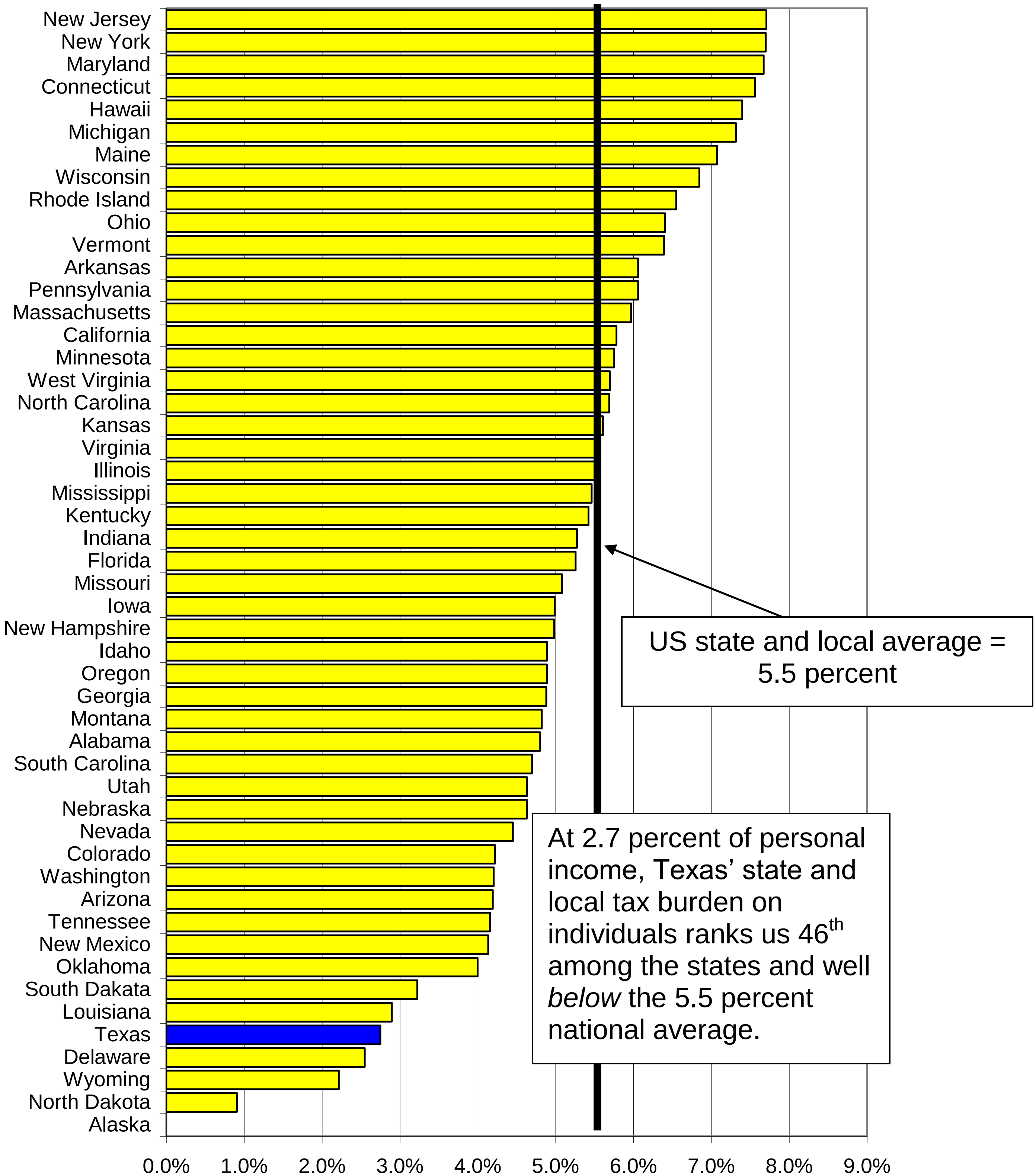
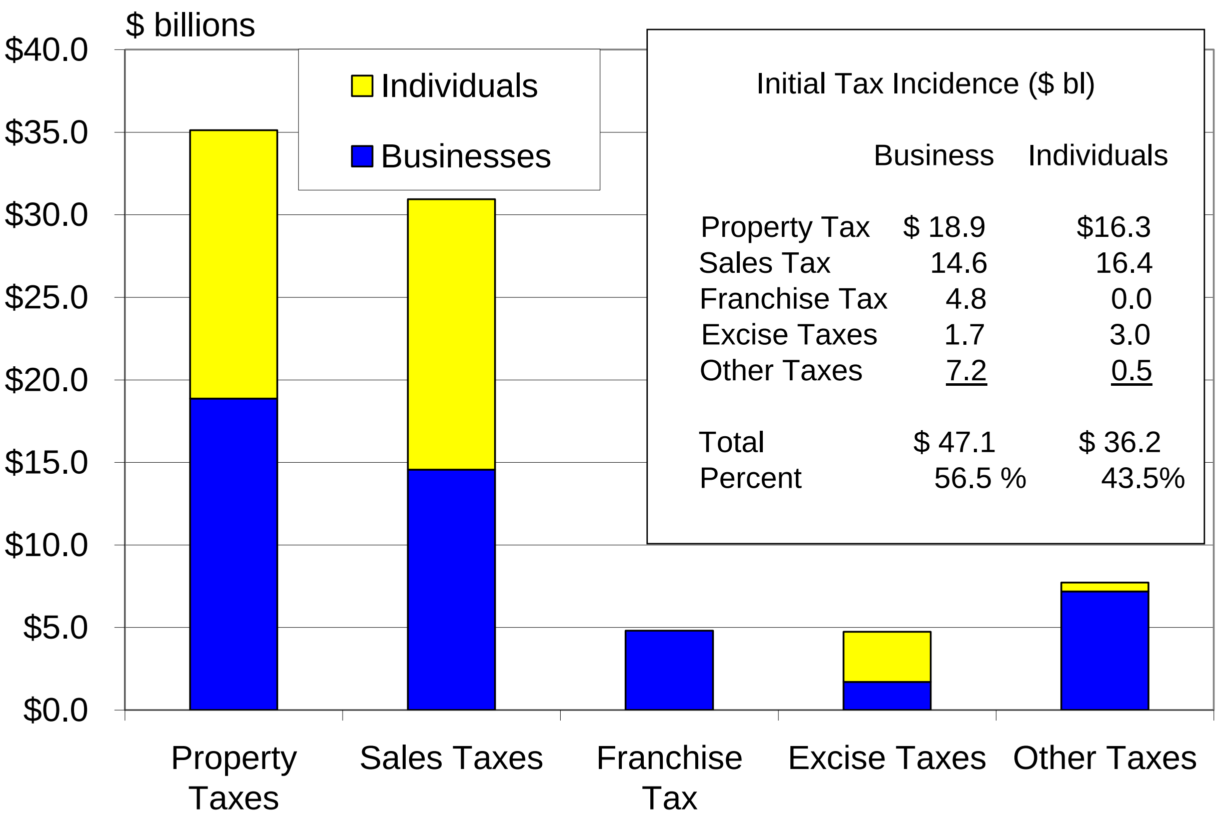
Individual Tax Burden Relative to Personal Income



Source: Derived from Council on State Taxation: Total State and Local Business Taxes, 2012.

Texas State and Local Taxes on Businesses and Individuals, 2008



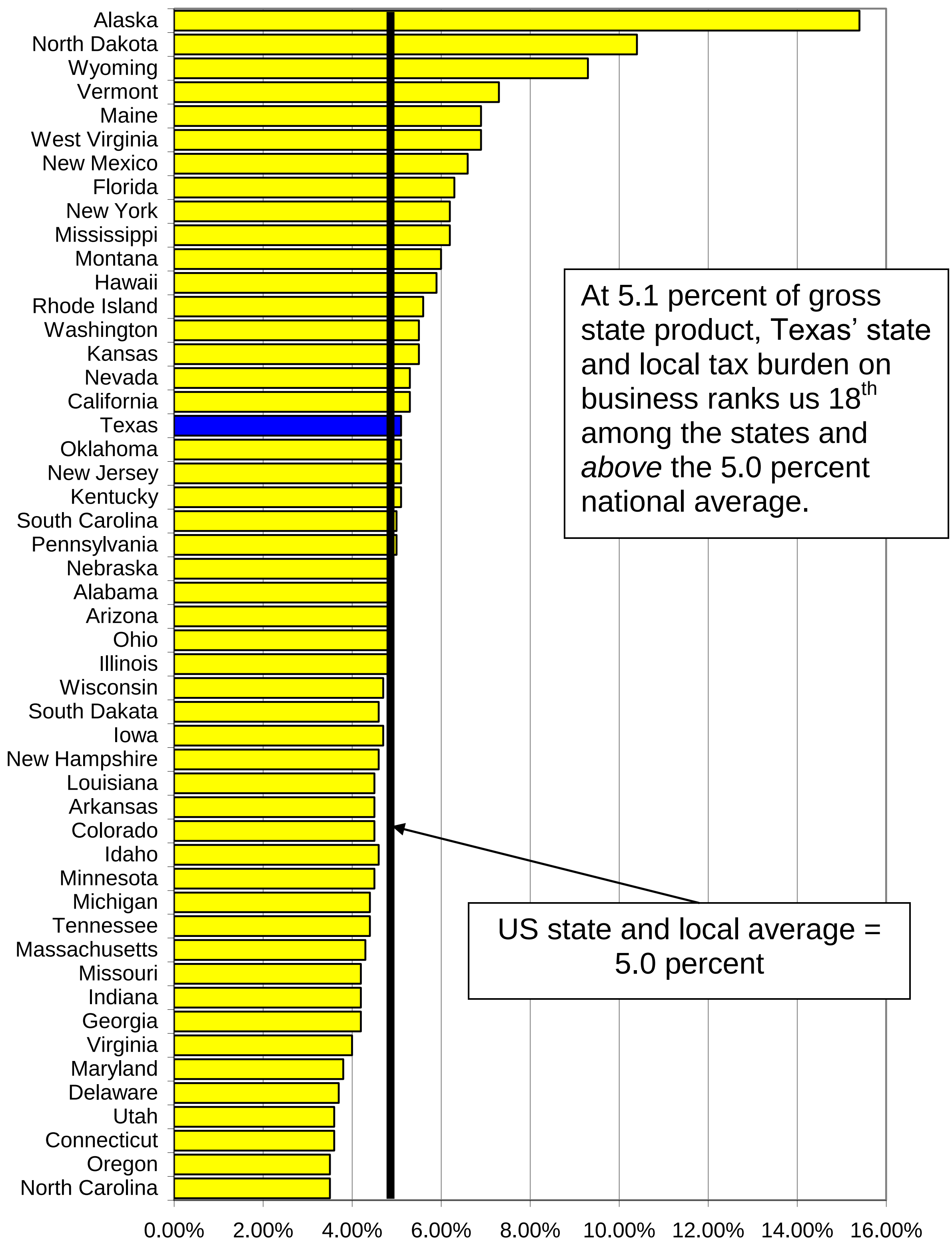
Source: Texas Taxpayers and Research Association

The biggest tax businesses pay in Texas is not the franchise tax—what is typically thought of as Texas' "business tax." The biggest tax paid by the business community is the property tax—levied by 1,024 independent school districts, 254 counties, over 1,000 cities, and overt 1,600 special purpose taxing units throughout the state.

School districts assess approximately 55 percent of all property taxes paid in the state, with cities and counties accounting for roughly 16 percent each and special districts approximately 12 percent.

The second largest tax businesses pay in Texas are the sales taxes paid to the state and to over 1,400 taxing jurisdictions—mostly cities, but also metropolitan transit authorities, and other special purpose districts.

Business Taxes Relative to Private Economic Output

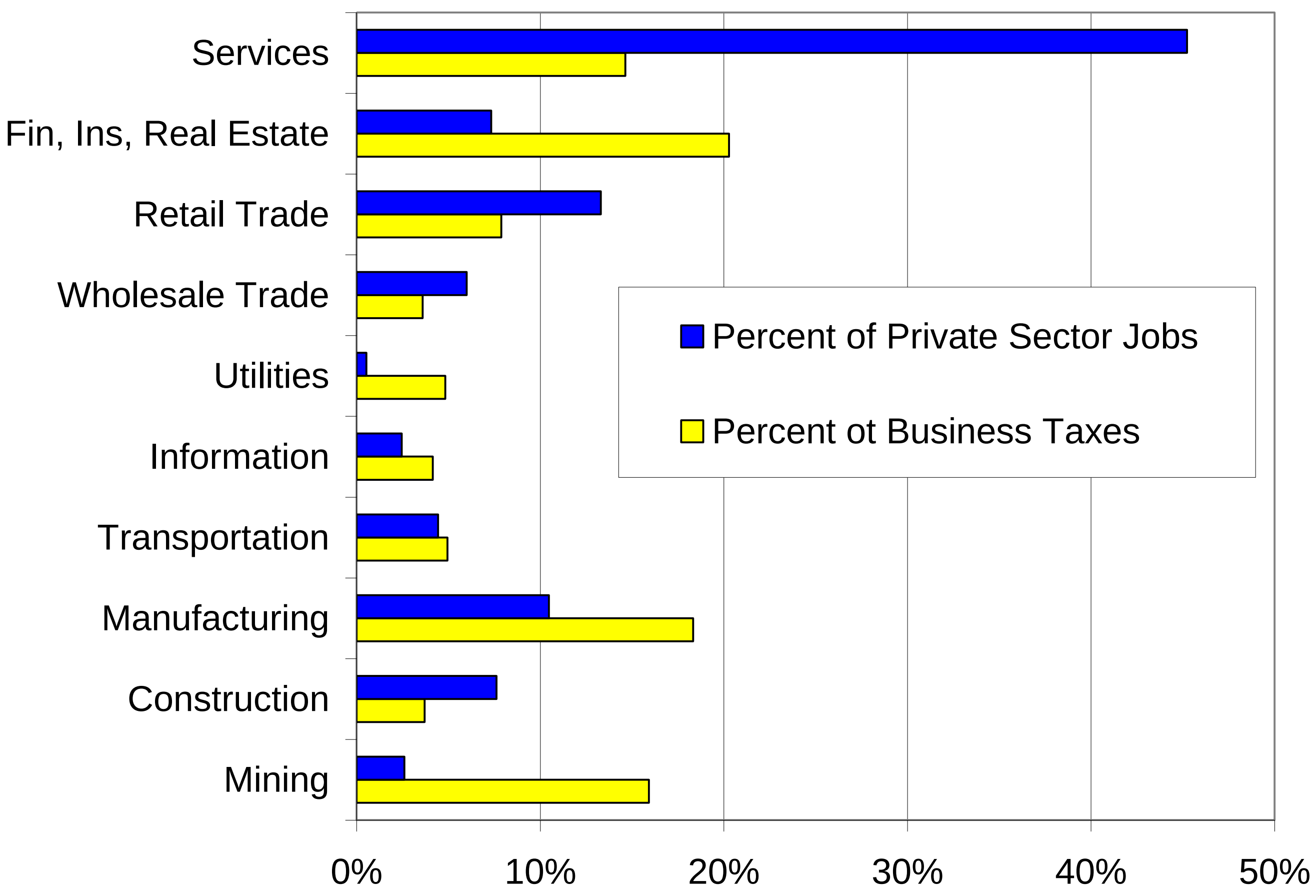


Source: Council on State Taxation: Total State and Local Business Taxes, 2012.

Comparing Key Texas Taxes to Other States

Tax	Current Rate and Base	Comparison
Sales Tax Rate	State Tax Rate: 6.25% Local Taxes: Generally capped at 2.0 %; average is 1.89% Average Combined Rate: 8.14%	State Rate: 13th (tied) highest Combined Rate: 11th highest
Sales Tax Base	Generally applies to all sales of tangible personal property excluding food, medicine and residential or industrial utilities; and a number of services	Texas' base is generally broader than that of other states because we tend to tax more services than other states (only 7 states tax more services)
Property Tax Rate	Residential property: average effective tax rate in 2010 was just under 2.0 percent of market value Industrial property: average effective tax rate in 2010 was about 2.5% of market value	Residential property: Texas' effective tax rates rank us 10th highest nationally **Industrial property: Texas' effective tax rates rank us 3rd highest nationally**
Property Tax Base	Texas taxes all real estate plus any tangible personal property used for business purposes (equipment and inventory); goods in interstate commerce are exempted at local option (i.e. Freeport property)	Texas' base is generally broader than that of other states: 9 states exempt all business tangible personal property; inventories are exempt in all but 9 states; 29 states offer some type of Freeport exemption
Business Franchise Tax	Texas' franchise tax is unlike the net business income tax levied by most other states; Texas' effective tax rate relative to economic output was 0.37% in 2011.	Relative to economic output, Texas' franchise tax ranks 24th highest among the states, but is about 6 percent below the national average.

The Mix of Texas Business Taxes and Texas Employment



Note: Data is from 2008.
Source: Texas Taxpayers and Research Association and the US Bureau of Labor Statistics.

Texas taxes are not evenly distributed across the economy.

Capital-intensive industries (finance, utilities, information, transportation, manufacturing, and mining) account for roughly 68 percent of all business taxes paid, yet account for only 28 percent of the state's private sector employment.

Labor-intensive industries (services, wholesale trade, retail trade, construction) account for roughly 32 percent of all business taxes, yet account for 72 percent of the state's private sector employment.

Over the previous 10 years, the services industry has accounted for two-thirds of the state's job growth.

Evaluating the Good and the Not-so-good about Texas Taxes on Business

Texas has a great deal to offer in attracting new business investment to the state, but our tax system is not necessarily a beneficial part of that evaluation.

Because of our heavy reliance on property and sales taxes, Texas' tax system falls heavily on the business community and in particular on capital intensive enterprises—oil and gas extraction, manufacturing, utilities, and real estate—in particular.

Our tax system falls relatively lightly on labor intensive enterprises such as services. These enterprises tend to use less capital to produce output.

Texas' lack of a state personal income tax is not solely of benefit to individuals; it also provides certain benefits to the business community, as well. It encourages small business development by allowing retention of capital which can be reinvested into the business. It also, in conjunction with certain favorable aspects of the franchise tax, makes Texas an attractive location for business headquarters. In 2012, 52 Fortune 500 companies were headquartered in Texas—up from 36 in 1998.

However, in the absence of a personal income tax, high property and sales taxes mean that Texas is not necessarily an attractive location for manufacturing plants and other capital intensive business operations.

Consequently, tax incentives can be an effective tool for mitigating the impacts of our high base level of business taxes. Texas local governments are able to offer new investment projects a temporary property tax abatement or limitation. Cities and counties are able to offer ten year abatement agreements; school districts may offer 8 year limitations on taxable value with a partial credit for the first two years of a project.

Q & A About the Texas Economic Development Act: Tax Code Chapter 313

What is The Texas Economic Development Act?

The Texas Economic Development Act, found in Chapter 313 of the Tax Code, allows a school district to offer a **temporary** limitation on the taxable value of certain new investment projects. Under Chapter 313, a local school district may offer up to an 8 year deferral before a new investment project goes onto the tax rolls at full value. This limitation does not take effect until the third year of the project; however, a taxpayer may make a separate application to the school district for a credit for taxes paid during those first two years on the value of property in excess of the limitation amount.

Why Was the Act Passed?

Chapter 313, the Texas Economic Development Act, was passed in 2001 as HB 1200. The original bill had five authors and 100 co-authors in the House. The bill was offered in response to Texas losing a number of major new industrial projects to other states—events largely attributable to the state's high property tax burden, and in particular, local school property taxes.

School districts had previously been able to offer tax abatements similar to those of cities and counties, but this authority was repealed in the mid 1990s. With the loss of school tax abatement authority, Texas fell from the nation's top industrial location in 1996, as ranked by Site Selection Magazine, to 37^{th} in 2000. Over those years, Texas lost 12 major facilities to other states—4 to Oklahoma alone.

What Types of Projects are Currently Eligible?

Only projects making new investments in connection with manufacturing, research and development, electricity generation using certain low emission technologies, nuclear energy. Computer centers in connection with any of these activities are also eligible.

How Many Jobs Must a Project Create?

The project must create 25 new jobs, or 10 jobs if the project is to be in a rural or economically disadvantaged school district. At least 80 percent of these jobs must pay 110 percent of the county's average manufacturing wage and provide health coverage. Projects creating over 1,000 jobs have a slightly lower wage threshold—100 percent of the county average wage. A school board can waive the jobs requirement if it makes a finding that the jobs creation requirement exceeds the industry standard for that particular type of facility.

How Much Investment Must Be Made, and How Much of a Limitation May a School District Offer?

The required amount of investment for a project to qualify differs depending on the property value of a school district. A higher level of investment is required in very large or property wealthy school districts than in smaller or less wealthy districts; smaller or less wealthy districts may offer a correspondingly lower value limitation, as shown in the following table:

Total Property Value of School District	Minimum Amount of Investment Required	Minimum Amount of Tax Value Limitation
$10 billion or more	$100 million	$100 million
$1 billion, but less than $10 billion	$80 million	$80 million
$500 million, but less than $1 billion	$60 million	$60 million
$100 million but less than $500 million	$40 million	$40 million
Less than $100 million	$20 million	$20 million

Are Certain School Districts Able to Offer Lower Limitations or Require a Lesser Amount of Investment to Qualify?

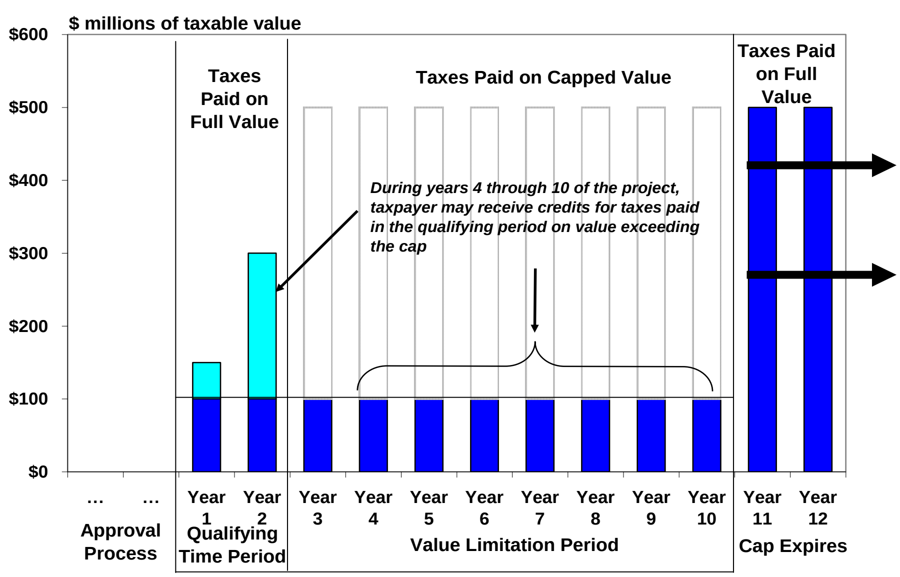
Yes. A school district that is in a "rural county (i.e. has a population less than 50,000, is not in a statistical metropolitan area, and did not experience population growth in the 1990s of more than three percent per year) or is in a "strategic investment area" may operate under lower thresholds, depending on their *industrial* value as shown in the next table. A "strategic investment area" is an area defined as a county with an unemployment rate above the state average and with a level of per capita income below the state average. Certain sub-county areas may qualify if they are a federally designated urban enterprise community, an urban enhanced enterprise community; or a defense economic readjustment zone designated under Chapter 2310, Government Code. A project qualifying under these provisions is eligible if it creates a minimum of 10 jobs, though the requirement may be waived by the school board if the jobs creation requirement exceeds the industry standard for that particular type of facility.

Industrial Value of School District	Minimum Amount of Investment	Minimum Amount of Tax Value Limitation
$200 million or more	$30 million	$30 million
$90 million, but less than $200 million	$20 million	$20 million
$1 million, but less than $90 million	$10 million	$10 million
$100,000 but less than $1 million	$5 million	$5 million
Less than $100,000	$1 million	$1 million

How Does the Program Work?

A taxpayer considering to build a new facility, or expand an existing facility, applies for a tax limitation to the school district in which the project will be located. In the example below, a taxpayer proposes to build a $500 million facility that will take two years to construct. The school district agrees to offer a value limitation of $100 million for maintenance and operations taxes.

The first two years after the application is approved are the "qualifying period," which in this case corresponds with the construction of the project. During these two years, the taxpayer pays property tax on the full value of the property, which the chief appraiser values based on the "construction in place." The school district may subsequently grant a credit to the taxpayer for the amount of taxes paid during the qualifying period on the amount of value in excess of the limitation amount. This credit typically begins in the fourth year of the project and is claimable in installments over 7 years. In the third year after the application is approved, the taxable value of the property associated with the project is capped at $100 million, and it remains capped for 8 years. The taxable value and the amount of the exempt value above the limitation are reported by the school district to the Comptroller as a part of their "self-report" of property value. In year 11, the limitation expires and the property goes onto the tax rolls at full value.



The table on the following page illustrates the numbers behind this example. The district, in this case, levies a maintenance and operations tax rate of $1.04. The tax is applied to the full, unlimited, value of the property in years 1 and 2, the qualifying period.

	Appraised Value	Taxable Value	School District Taxes Due	Credit for Initial Taxes	Net School District Taxes Due	Applicant's Tax Savings
Year 1	$150.00	$150.00	$1.56		$1.56	$0.00
Year 2	$300.00	$300.00	$3.12		$3.12	$0.00
Year 3	$500.00	$100.00	$1.04		$1.04	$4.16
Year 4	$500.00	$100.00	$1.04	$0.37	$0.67	$4.53
Year 5	$500.00	$100.00	$1.04	$0.37	$0.67	$4.53
Year 6	$500.00	$100.00	$1.04	$0.37	$0.67	$4.53
Year 7	$500.00	$100.00	$1.04	$0.37	$0.67	$4.53
Year 8	$500.00	$100.00	$1.04	$0.37	$0.67	$4.53
Year 9	$500.00	$100.00	$1.04	$0.37	$0.67	$4.53
Year 10	$500.00	$100.00	$1.04	$0.37	$0.67	$4.53
Year 11	$500.00	$500.00	$5.20	$0.37	$5.20	$0.00
Year 12 and all future yrs	$500.00	$500.00	$5.20		$5.20	$0.00

All dollars in millions. Assumed school tax rate is $1.04 per $100 of taxable value.

The full amount of property taxes due in year 1 and two are $1.56 million and $3.12 million, respectively. In year 3, the value limitation takes effect; the property is valued at $100 million for tax purposes, for a tax liability of $1.04 million. In year 4, if the school district has approved, the taxpayer may begin to claim a credit for the taxes paid in the first two years on the amount of the property in excess of the value limitation granted—claimable in one-seventh increments through the tenth year of the project. The annual net tax liability in these years is $0.67 million. With the limitation expiring in year 10, the property is fully valued at $500 million and the resulting tax liability is $5.2 million annually.

Do School Districts Receive Supplemental Payments?

To grant a property value limitation a school district must enter into a legal agreement with the owners of the new investment. State law requires that the agreement provide that the applicant will protect the school district from any loss of state aid associated with the limitation ("revenue protection payments").

Many agreements also provide for *additional* amounts termed "payments in lieu of taxes," (aka "PILOTs" or "PILTs") in which the applicant agrees to make additional payments to the school district. Under House Bill 3676 enacted in 2009, these supplemental payments may not exceed $100 per student each year the agreement is in effect. This limit was adopted in response to high levels of supplemental payments that in some cases were as much as 40 percent of the overall tax savings. In one instance *after* the $100 limit was imposed, an agreement was entered into in which the applicant was required to provide additional funds to a non-profit foundation established to support the school district. The Comptroller has subsequently adopted rules which allow her to review the proposed agreements in an effort to reign in these violations of the spirit of the law.

How Do the Property Value Limitations Affect State Aid and School Finance?

State aid to school districts is based on a complicated set of formulas that take into account the local property value wealth of a school district and is used to "equalize" wealth disparities across districts. A property poor school district receives relatively more state aid than a mid-wealth district, and a very wealthy district may actually have to return a portion of its local tax collections to the state through "recapture."

When a school district offers a value limitation, it only taxes the amount of the property up to the value limit and temporarily exempts the portion of the value in excess of the limit. The state does not count exempt property as a part of a local district's property tax wealth because the district does not collect tax on it—be it a homestead exemption, an appraisal cap, or a value limitation under Chapter 313. Consequently, as the project expands above the value limit, the state does not reduce the amount of state aid due to the district under the equalization formulas. It is not a matter of the state *sending extra money* to a district for the amount of Chapter 313 property the district exempts, it is a matter of the state *not reducing* its aid to the school district as a result of property the school district does not tax.

When the property does go onto the local tax rolls at full value, all things being equal, the state will *reduce* the amount of aid it provides the district.

How Much Do These Agreements "Cost" the State?

While some studies identify the "cost" of the program as the amount of taxes temporarily forgone, the truth is that absent the tax incentives, many if not most of these projects would not have located in Texas. Texas would not "save" money by eliminating the program for new investment because projects would likely choose to locate in other states.

The competition to attract new investment to states is fierce, and typically the Chapter 313 applicant has other location choices outside of Texas. Projects will narrow their location decisions based on a variety of factors such as quality of the workforce, transportation networks, regulatory environment, etc. Once narrowed to a few locations, businesses will engage in more direct discussions with states and communities concerning infrastructure and incentives, including taxes. Tax incentives can be a key factor in the final decision of where to invest. Absent the tax incentives, many of the projects would not locate in Texas.

TTARA Recommendations on Chapter 313

- **Extend the program, permanently.** Temporary reauthorizations confuse businesses and imply that Texas is not committed to economic development.

- **Begin the limitation in Year 1.** Under current law the limitation does not take effect until year 3, though the taxpayer may file for a credit for taxes paid on value in excess of the exemption during the first two years of the project (an approach crafted in order to reduce the initial fiscal cost of the program). Instead of this unwieldy pay/apply/credit, the limitation should apply immediately, as do city/county abatements.

- **Simplify the statutory application and reporting requirements.** The original application for a Chapter 313 limitation is 16 detailed pages plus a requirement that an economic study must be completed. A separate 4 page detailed application is required if the project wishes to receive a tax credit for amounts paid on value in excess of the limitation during the first two years of the project. The applicant then must file a 3 page "annual eligibility" report. A separate 4 page "biennial progress report" must be filed every other year. A participating school district must file a biennial report on each limitation agreement, as well. Many other states and even Texas' own city and county abatement process has a simple one or two page application with minimal reporting requirements.

- **Simplify the benefits structure.** Current law establishes a complicated set of 10 different levels of investment and limitations based on the size of a school district and the economic conditions of the county. A simpler structure would make the program easier to understand.

- **Establish rational and reasonable evaluation criteria.** Chapter 313 suffers from statutorily-required information reporting overload, much of which is unnecessary to determine if the program is meeting its original stated purposes. In effect, there are too many trees for the forest to be seen. The state should establish a simple set of criteria to evaluate projects and the program in its entirety.

- **Consider extending the program to additional "target" industries.** The program is currently crafted narrowly to apply to only certain types of manufacturing, research and development, or energy projects. The program should be extended to certain "target" industries that Texas wishes to attract.

- **The wage and health benefits requirements should be reviewed.** The statute provides multiple wage thresholds and the requirement that an employer must pay 80 percent of the cost of health insurance may no longer reflect industry standards.