

THBI Special Session Summary
79th Legislature 3rd Called Special Session
May 17, 2006

The Texas Legislature adjourned Sine Die on May 15, 2006, after 29 days of fast and furious work on property tax reduction and school finance to satisfy a court order. Both chambers managed to agree to five different aspects of a plan, proposed largely in part by Governor Perry, to reduce property taxes while broadening the franchise tax, increasing the tax on cigarettes and cigars, solidifying how the sales tax on used motor vehicles is to be collected, and making reforms to the public education system. In addition, the legislature managed to take care of unfinished business in the form of an omnibus tuition revenue bond bill and passed various other measures included in the call late during the special session.

THBI was involved even before the session began expressing concern about the needs of the research and development community to the Texas Tax Reform Commission and the necessity of analyzing the impact different franchise tax changes would have on the economic development and growth of the life science industry in Texas. During the special session, the Texas Healthcare and Bioscience Institute tracked 45 bills with potential impact to THBI members and the legislative committee met regularly to discuss strategy and the ramifications of franchise tax on individual member companies. THBI also walked the halls in both the House and Senate educating elected officials about how changes in the current franchise tax system might affect the life science businesses in Texas and how to minimize any negative effects through thoughtful changes to the tax code.

Background

The Supreme Court of Texas concluded their determinations in the West Orange-Cove Consolidated ISD lawsuit against the state and announced their ruling on November 22, 2005. At issue were three separate challenges to the current finance system for Texas schools by three groups comprised of numerous school districts throughout the state.

- The first challenge was on adequacy, or the ability of school districts to provide a general diffusion of knowledge and skills to students. The school districts argued that they are not able to provide for a general diffusion of knowledge because the system is under-funded. The Supreme Court made a modification to the law with regards to this challenge stating that the system of financing our public schools is adequate if districts are reasonably able to provide their students access and opportunity to acquire the essential knowledge and skills. The Court ruled that at this time, there is enough funding in the system for this reasonable ability.
- The second challenge from the schools was the efficiency of the system, more commonly voiced as children in property-poor school districts having substantially equal access to education revenue as those in property-rich districts. The schools argued that the current school finance system is inefficient in this respect because there is not enough money in the system to provide for the

- maintenance, operation, instruction, and facilities to be substantially equal. The Supreme Court denied this challenge contending that the system was not built to be perfectly equal in funding for all districts and that the gap which exists between property-poor districts and property-rich districts is not enough to prohibit substantially equal access to education.
- Finally, the third charge by the schools was that the current system of funding public schools primarily through school property taxes has in effect become a statewide property tax because of the number of school districts that have reached the maximum cap of \$1.50 per \$100 valuation. The Supreme Court on this challenge agreed that school districts have lost meaningful discretion to tax below the cap and still provide an accredited education, thus it is a statewide property tax and is unconstitutional.

The Supreme Court then gave the Texas Legislature a **deadline of June 1, 2006**, to devise a school finance plan that is constitutional and maintains the standards of adequacy and efficiency.

Governor Perry appointed a Texas Tax Commission chaired by former Comptroller John Sharp to consider how to reform the current tax structure in order to fund our schools. The 24 member commission held public hearings around the state to gather input before making their recommendations to the Texas Legislature for tax reform in March. THBI participated by providing input to the Commission on the life science industry in Texas and economic development policies of importance to life science companies. Governor Perry called the legislature back to Austin on April 17.

Property Tax Reform and School Finance

The Texas Healthcare and Bioscience Institute closely followed the five bills constituting the property tax reduction and school finance proposal. The reform package is as follows:

- **House Bill 1** – The major school reform bill which includes numerous changes including but not limited to: a \$2000 teacher pay raise, reforms to the wealth-per-student requirements for school districts and maintenance and operations taxes, fiscal accountability and administrative efficiency measures for school districts, a wage increase for full-time support staff of \$500, academic accountability measures, incentive programs, and changes to the school start date. House Bill 1 also appropriates \$3.825 billion to implement the reforms of the bill and help with property tax reduction.
- **House Bill 2** – This bill establishes a property tax relief fund and dedicates all of the revenue from House Bills 3 (the franchise tax), 4 (used motor vehicle sales tax), and 5 (cigarette and tobacco tax increase) to the reduction of property taxes. The bill stipulates that if property taxes are reduced to an average of \$1.00 per \$100 valuation, two-thirds of the fund will then be used to continue to buy down

property taxes and the remaining one-third will be used to increase the level of equalization of school district enrichment tax effort.

- **House Bill 3** – This is the major franchise tax reform bill. It expands the number of businesses paying the franchise tax. Currently, only around one in 16 businesses pays the tax. House Bill 3 establishes the tax rate at 1% per year of taxable margin on entities doing business in the state, or .5% per year of taxable margin on entities primarily involved in retail or wholesale trade in Texas. The bill calculates the taxable margin as the lesser of 70% of a taxable entity's total revenue or a taxable entity's total revenue minus either the cost of goods sold or compensation. If a business chooses to deduct the cost of goods sold, it is entitled to deduct of the cost of goods and all direct costs of producing the goods including but not limited to: labor costs, costs of integral materials, handling costs, storage costs, costs of renting or leasing equipment or property directly used in the production of the goods, repair and maintenance costs, and research, experimental, engineering and design activities related directly to the production of goods. Businesses that are sole proprietorships or which have total revenue equal to or less than \$300,000 are exempt from paying the franchise tax. General partnerships directly owned entirely by natural persons and passive entities are also exempt from the franchise tax.
- **House Bill 4** – The bill establishes a standard presumptive value for private-party motor vehicle sales. This bill is designed to help increase the amount of sales tax revenue the state receives from used motor vehicles by establishing guidelines on which to base the appraisal and collection of sales taxes.
- **House Bill 5** – This bill increases the tax on a pack of cigarettes by \$1. It also increases the tax on tobacco other than cigars from 35.213% to 40% of the manufacturer's list price.

All five bills were passed by the legislature and have been sent to the Governor for his signature. The package is estimated to bring in enough revenue to replace the franchise tax and buy down property taxes in addition.

*Note: A full summary of each bill is available by contacting THBI.

Research and Development Tax Credits

Currently, there are several economic development incentive packages for life science and manufacturing companies established in Texas statute.

The Texas Economic Development Act, Chapter 313 in the Tax Code, was created in 2001 by the 77th Legislature to encourage capital investments in Texas, create new high-paying jobs in Texas, attract large-scale companies exploring opportunities in other states to Texas, and enable local governments and economic development professionals to compete with the incentives offered by other states. The Legislature created a limitation on the appraised value of property such as land or new buildings which will result in the

creation of new permanent full-time jobs in Texas. The property must be used in connection with manufacturing, research and development, clean coal projects, coal/biomass gasification projects, or renewable energy electric generation.

This economic development incentive was set to expire on December 31, 2007. An amendment was added during this 3rd called special session to House Bill 3 to extend that expiration date until December 31, 2011.

Another economic development incentive is contained in the Franchise Tax portion of the Tax Code as well (Chapter 171). Since the Legislature was making a complete overhaul of the franchise tax in order to close loopholes and include more businesses, there was concern that these incentives might be abolished or inadvertently omitted. The incentives include a franchise tax credit for certain research and development activities, a credit for certain job creation activities, and a credit for certain capital investments. House Bill 3 did abolish the three subchapters in which these credits are contained. Legislators refused to offer up amendments to House Bill 3 on this issue because it came at a high cost to the bill, however, several legislators have expressed interest in working with coalition of interested parties, including THBI, in reviving these credits during the next regular session beginning in January of 2007.

House Bill 3 did make provisions to allow those companies qualifying for and receiving these franchise tax credits before the effective date of the bill to continue to apply their unused tax credits until they expired or a set date being: December 31, 2027, for R&D credits; December 31, 2012, for job creation credits; and December 31, 2012 for capital formation credits. THBI will work with an organized coalition of other companies across multiple industries all of whom have a strong interest in the economic development incentives during the next regular session to push for the reinstatement of these credits. This coalition has already been formed and is meeting on a regular basis to discuss strategy.

Tuition Revenue Bonds

During the 79th regular legislative session and the ensuing 2 special sessions, one piece of legislation of importance to the members of THBI failed to pass: it contained tuition revenue bond requests for Texas' academic institutions. In the final weeks of this 3rd called special session, Governor Perry opened the call of the session to include legislation authorizing tuition revenue bonds for our institutions of higher education, many of which perform the necessary research vital to our life science industry. These tuition revenue bond bills allocate money to the universities and academic research institutions in Texas in the form of bonds to allow them to build facilities, buy important equipment and fund other necessities for growth and continued research and education at colleges and universities. When bills filed for this purpose do not pass, universities are put in the tough position of trying to find funding for these projects through other avenues in an already tight investor economy.

During this special session, House Bill 153 was filed as an omnibus tuition revenue bond bill containing the requests of many of the state-funded higher education institutions. It contained such vital revenue requests as the University of Texas Medical Branch in Galveston's National Biocontainment Laboratory, one of only two such facilities in the country constructed with grants from the National Institute of Allergy and Infectious Diseases/National Institutes of Health; a request from the world renowned cancer center, MD Anderson for a Center for Targeted Therapy research building; and funding for an Emerging Technologies Interdisciplinary building for Texas A&M University.

Opponents of stem cell research tried to place an amendment on this bill which would have set a precedent of the legislature dictating what types of research the state's academic institutions are permitted to conduct. The amendment was far-reaching beyond current federal policy and would have prohibited the use of state funds as well as private funds to conduct certain aspects of stem cell research at these facilities funded by the bonds, not only now, but in to the future as well, regardless of how federal policy changed. This important tuition revenue bond bill was not the appropriate venue for the debate on stem cell research and these opponents' actions jeopardized the potential for the bill and the much needed bonds for institutions of higher education to pass. THBI working continuously with a coalition of interested parties to urge passage of the bill without detrimental and prohibitive amendments and by the time the session concluded, House Bill 153 was passed without controversial and precedent-setting language. The issue will continue to surface and this debate is an indicator of those to come in the next regular session over the types of research that should and should not be conducted in Texas. THBI will continue to advocate for legislative policies that promote growth and expansion of the life sciences and will work with other stakeholders to oppose legislation with the potential to chill the strong research and development environment Texas is nurturing.

The legislature has concluded its work and has adjourned until the 80th legislative session which is scheduled to begin January 9, 2007.