HOUSE COMMITTEE ON WAYS AND MEANS
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2002

A REPORT TO THE
HOUSE OF REPRESENTATIVES
78TH TEXAS LEGISLATURE

RENE O. OLIVEIRA
CHAIRMAN

COMMITTEE CLERK
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Committee On
Ways and Means

November 25, 2002

Rene O. Oliveira
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P.O. Box 2910
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The Honorable James E. "Pete" Laney
Speaker, Texas House of Representatives
Members of the Texas House of Representatives
Texas State Capitol, Rm. 2W.13
Austin, Texas 78701

Dear Mr. Speaker and Fellow Members:

The Committee on Ways and Means of the Seventy-Seventh Legislature hereby submits its interim report including recommendations and drafted legislation for consideration by the Seventy-Eighth Legislature.

Respectfully submitted,

Rene O. Oliveira, Chairman

Rep. Brian McCall, Vice-Chair

Rep. Dennis Bonnen

Rep. Tom Craddick

Rep. Yvonne Davis

Rep. Will Hartnett

Rep. Talmadge Heflin

Rep. Jim Keffer

Rep. Tom Ramsay

Rep. Debbie Riddle

Rep. Alan Ritter

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INTRODUCTION

At the beginning of the 77th Legislature, the Honorable James E. "Pete" Laney, Speaker of the Texas House of Representatives, appointed eleven members to the House Committee on Ways and Means. The committee membership included the following: René O. Oliveira, Chair; Brian McCall, Vice-Chair; Dennis Bonnen; Tom Craddick; Yvonne Davis; Will Hartnett; Talmadge Heflin; Jim Keffer; Tom Ramsay; Paul Hilbert; and Alan Ritter. Later, due to the untimely death of Representative Paul Hilbert, Representative Debbie Riddle was added to the committee.

During the interim, the committee was assigned the following charges by the Speaker:

1. Review the laws and procedures governing appeals of appraised values for property tax purposes. Consider whether a low-cost alternative to district court would be beneficial in disputes involving small amounts of money. Also review the process by which the Comptroller of Public Accounts reviews and adjusts the values assigned by appraisal districts, including possible hardships on local taxing jurisdictions when adjustments are made.

2. Review the dedicated uses of the additional municipal sales and use tax, sales and use taxes imposed under Chapter 451-453 of the Transportation Code, sales and use taxes for special purpose taxing authorities, county sales and use taxes, county health services sales and use tax, and county sales and use tax for landfill and criminal detention centers, and municipal and county hotel occupancy taxes. Assess the impact such taxes have on the ability of communities to respond to changes in demand for and use of governmental services.

3. Continue to study the economic impact of internet commerce on state and local tax revenues, and monitor federal legislation and action relating to Internet taxation, including state participation in multi-state efforts to simplify the administration of sales and use taxes.

4. Review the effects of franchise tax credits authorized S.B. 441, 76th Legislature, and evaluate their success in achieving legislative goals.

5. Actively monitor agencies and programs under the committee's oversight jurisdiction.

In order to undertake the committee's charges efficiently and effectively, the House Committee on Ways and Means conducted a public hearing in Austin. The committee produced the following report, based on testimony from the hearing and other research. The members approved all sections of the report.

While the committee was able to develop recommendations to achieve various policy goals, the committee did not have conclusive information regarding available revenue for tax initiatives or complete information on the cost of such initiatives. Therefore, the committee only outlines strategies for meeting specified policy goals, rather than recommending priorities for or actions by the 78th Legislature.

Finally, the committee wishes to express appreciation to the committee staff; the staff of committee members; to agency personnel that assisted the committee, including the Office of the Comptroller

of Public Accounts, and the citizens who testified at the hearings for their time and efforts.

HOUSE COMMITTEE ON WAYS AND MEANS

INTERIM STUDY CHARGES

1. Review the laws and procedures governing appeals of appraised values for property tax purposes. Consider whether a low-cost alternative to district court would be beneficial in disputes involving small amounts of money. Also review the process by which the Comptroller of Public Accounts reviews and adjusts the values assigned by appraisal districts, including possible hardships on local taxing jurisdictions when adjustments are made.

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CHARGE 1

Review the laws and procedures governing appeals of appraised values for property tax purposes.

Review the process by which the Comptroller of Public Accounts reviews and adjusts the values assigned by appraisal districts, including possible hardships on local taxing jurisdictions when adjustments are made.

BACKGROUND

Texans pay more in property taxes than for any other state or local tax. The property tax system is

also the most contentious of the tax systems, partly because of its connection with the formulas for distributing state aid to local schools which is the largest single item in the state budget. The distribution of state aid to public schools is based on the Comptroller's annual study of school-district property values. The most controversial issue within the property tax system is the appraisal of taxable property within each taxing entity, especially as local property valuations and tax bills continue to rise. Statewide, the taxable value of single-family dwellings rose by 40% from 1996 to 2001.[1]

APPEALS OF APPRAISED VALUES

There are many complaints about the current appraisal system that often lead to appeals from the local appraisal of property. Some of the major issues raised are regarding the accountability and practices and procedures of appraisal districts.[2]

TAXPAYER APPEALS

Property taxes by nature are local taxes, therefore it is local officials that value the property, set the tax rates, and collect the taxes. The local property system does follow a principle of checks and balances. An appraisal district board hires the chief appraiser and sets the budget. The directors have no authority to set values or appraisal methods. The chief appraiser carries out the appraisal district's legal duties, hires the staff, makes the appraisals, and operates the appraisal office.[3] That said however, it is state law that governs how taxpayers may challenge the process. Chapters 41 and 42 of the Tax Code provide the administrative and judicial remedies for any errors, protests, and appeals.

Appraisal District Level

It is at this level that the disputes arise. A taxpayer may file a protest with their local appraisal district, (CAD), if they disagree with virtually any action or decision the appraisal district has taken on the taxpayer property. Among the many grounds for protest, a taxpayer may protest the following:

- market or special appraised value placed on the property;
- unequal appraisal of the property;
- thin inclusion of property on the appraisal roll;
- issue of any exemptions that may apply to the property;
- qualification for agricultural or timber appraisal of the property;

[1] Patrick K. Graves, "Property Tax Appraisal: Issues and Responses," Focus Report, House Research Organization, August 5, 2002.

[2] Ibid.

[3] "2001 Texas Property Tax Appraisal Review Board Manual, " Texas Comptroller of Public Accounts.

- taxable status of property;
- local governments which should be taxing property;
- ownership of property;
- change of use of land receiving special appraisal; and
- generally any action taken by the chief appraiser, appraisal district or appraisal review board that applies to and adversely affected property owner.

Although there are, as listed above, many grounds for challenging an action taken by the local appraisal district, it is however, a challenge to the valuation of their property that is the most common ground of dispute. If a taxpayer disagrees with the valuation of their property by their local appraisal district, the first step they can take is request that their appraisal district informally review the valuation of their property. As stated, this initial step is an informal one that can vary from appraisal district to appraisal district. It is also at this stage that a majority of the disputes between the taxpayer and the appraisal district are resolved.[4] For example, the Harris County Appraisal District, which is the second largest appraisal district in the nation, resolves approximately 80% of the 130,000 to 170,000 protests it receives per year through this informal mechanism.[5]

Appraisal Review Board

If however no resolution is reached between the taxpayer and the appraisal district, the taxpayer may then appeal the appraisal district's decision to the Appraisal Review Board, (ARB).

The ARB is the judicial component of the property tax system. The ARB is a separate body from the appraisal district offices and serves a different function. It hears and resolves disputes over appraisal matters. The ARB only has authority over matters submitted to it. The ARB has no role in the day-to-day operations of the appraisal office or in appraising property. Except where it is deciding a property owner protest, taxing unit challenge, or a correction motion, the ARB has no authority to change a value or correct the appraisal records directly. Only in resolving taxpayer protests can the ARB make changes or set a value on its own, and only to the property in question.[6]

The ARB is made up of a group of citizens that is authorized to review problems between taxpayers and the appraisal districts. Therefore, the ARB has the power to order the appraisal district to make any and all necessary changes to solve problems. These citizen members are appointed by the appraisal district's board of directors. In order to serve on the ARB, an individual must be a resident of the appraisal district for at least two years. In would appear that in order to avoid an appearance of impropriety or conflict of interest, current officers and employees of the appraisal district, taxing units, and State Comptroller's office are prohibited from serving on the board. Additionally, in

[4] Testimony of Jim Robinson, Chief Appraiser, Harris County Appraisal District, Ways and Means Committee Hearing, April 24, 2002.

[5] Ibid.

[6] 2001 Texas Property Tax Appraisal Review Board Manual, Texas Comptroller of Public Accounts.

counties with a population of 100,000 or more, even former directors, officers, and employees of the appraisal district can not serve on the ARB. Additionally, all members that serve on the ARB must also comply with special conflict of interest laws.[7]

When a taxpayer chooses to challenge the valuation as performed by the appraisal district, the taxpayer can appeal to the ARB by submitting a written request called a 'notice of protest'. A copy of the protest form may be obtained by the taxpayer from the taxpayer's appraisal district office. However, an official form is not necessary if the notice of protest identifies the property owner (taxpayer), the property that is subject of the protest, and indicates that the taxpayer is dissatisfied with the decision made by the appraisal district. The request must be filed before the deadline in order for the ARB to set the case for a hearing.[8]

The usual deadline for submitting a notice of protest is on or before May 31, or 30 days after a notice of appraised value is mailed to the property owner, whichever is later. In some cases late protests are allowed if good cause for missing the deadline exists. It is ultimately up to the ARB to determine what constitutes 'good cause'. However, good cause in most cases is a reason beyond the taxpayers control, such as a medical emergency. These late protests are due before the board approves the records for the year.[9]

Special Deadlines

The deadline on submitting a protest can vary, depending on the nature of the protest. In the case of a change of use of the property, the deadline is before the 30th day after the notice of determination by the appraisal district was mailed. An example of this kind of protest would be if the appraisal district informed the taxpayer that the agricultural appraisal is not valid because the taxpayer has changed the use of the land. If the ARB ordered a change that did not result from a filed protest, such as a change in the taxpayer's property's records, the notice of protest must also be filed within 30 days of the date on which the ARB mailed a notice of the change.[10] However, in all of these cases, if a taxpayer does not file a notice of protest before the ARB approves the appraisal records for the year, then the taxpayer loses the right to protest. Additionally, the right to file a lawsuit about the taxable value of the property is also lost.[11]

In cases where the taxpayer believes the appraisal district or ARB failed to send notice, then a

[7] "How To Protest Your Property Value for Property Taxes," Texas Property Taxpayers' Remedies, Texas Comptroller of Public Accounts, January 2002.

[8] Ibid.

[9] "Property Tax Protest and Appeal Procedures," Form 50-195, Texas Comptroller of Public Accounts.

[10] Ibid.

[11] "How to Protest Your Property Value for Property Taxes," Texas Property Taxpayers' Remedies, Texas Comptroller of Public Accounts, January 2002.

protest may be filed before the taxes become delinquent, which is usually by February 1st. The ARB ultimately has discretion to decide whether or not it will hear a case based on evidence about whether or not a required notice was mailed. If however, the taxes on the property are delinquent, then the right to file a protest is lost. It is important to note that in order to be entitled to a hearing, the taxpayer is required to pay a partial amount of the taxes prior to their becoming delinquent. In most cases it is usually the amount of taxes that are not in dispute.[12]

Once the ARB receives the written request, it will set the case for a hearing and notify the taxpayer by written notice of the time, date and place of the hearing. The notice is sent to the taxpayer at least 15 days in advance of the date of the hearing. If necessary, a taxpayer has the option of requesting a hearing in the evening, Saturday, or Sunday.[13]

Prior to the hearing, a taxpayer has the right to ask to review the evidence that the appraisal district plans to use to hold up their determination. By law, the chief appraiser of the local appraisal district must deliver certain materials to the property owner at least 14 days prior to the hearing. Among the information to be provided are: 1) a copy of the Comptroller's publication, "Taxpayers' Rights, Remedies & Responsibilities"; 2) a copy of the ARB's hearing procedures; and 3) notify the property owner that the owner has a right to inspect and copy data, schedules, formulas, and any other material the chief appraiser plans to introduce at the hearing. Failure to comply with the delivery requirements requires the ARB to postpone the hearing if the taxpayer asks for more time to prepare.[14]

Additionally, the taxpayer is also entitled to ask, among other things, that the appraisal district explain the appraisal, to be provided with appraisal records on similar properties in the taxpayer's area, for sales records the appraisal district used in the valuation, and why the appraiser denied any exemptions or applications for exemptions. There are however limits as to what is available for disclosure by the appraisal district, however it appears that the taxpayer is eligible to obtain a vast amount of information from the appraisal district. In the same manner, the appraisal district may request from the taxpayer a copy of the evidence the taxpayer plans on presenting at the hearing.

Additionally, there is statutory authority that requires that the ARB's protest procedures be delivered to the taxpayer upon request, at least 10 days prior to the hearing. It is unclear however, which entity is responsible for providing the information. Moreover, the Comptroller, appraisal district, and ARB notice of protest forms have a space for the taxpayer to "accept of decline" delivery of the procedures. It must be noted that up until the date of the hearing, a taxpayer may still work out a solution with their appraisal district without having to appear before the ARB. If both parties come to an agreement, they need to submit to the ARB a signed settlement and a waiver of protest form.

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[12] Ibid.

[13] "Property Tax Protest and Appeal Procedures," Form 50-195, Texas Comptroller of Public Accounts.

[14] "Resolving Disputes and Approving Appraisal Records," 2002 Texas Property Tax Appraisal Review Board Manual, Texas Comptroller of Public Accounts.

The ARB may not review or reject agreements between the taxpayer (or an agent of the taxpayer) and the appraisal district.[15]

Hearing

All ARB meetings must comply with the Open Meetings Act in accordance with Chapter 551 of the Government Code. Notice of the date, time, and place of each meeting must be posted at least 72 hours in advance at the appraisal district office and at the county clerk's office. The hearing procedures must also be posted, in a prominent place in the room in which the hearings are to be held. Additionally, the appraisal district's chief appraiser must publicize annually the right to and methods for protesting before the ARB.[16]

The hearing format before the ARB is also an informal one where the taxpayer may appear in person to present the evidence. However, the taxpayers physical appearance is not required and a taxpayer may instead send a designated agent or notarized evidence, including a sworn affidavit from the taxpayer for the ARB to review at the hearing. There is an official form that can be requested from the appraisal district or the Comptroller's Office, for taxpayers wishing to submit notarized evidence in lieu of their appearance, however it is not necessary to use this official form.

At the hearing, the ARB listens to both taxpayer and the appraisal district representative prior to making a decision. The taxpayer and appraisal district representative are both required to take an oath prior to presentation of the evidence. The burden is on the appraisal district of establishing the property's value by a preponderance of the evidence presented. If the appraisal district fails to meet this burden of proof, then the ARB must determine in favor of the taxpayer.

The ARB may make is decision at the conclusion of the hearing or postpone the decision to a later date. If the ARB divides into panels to hear separate cases, a hearings panel can not make a final decision, the decision is final only after a majority of the entire ARB approves a panel's recommendation. If the ARB postpones a decision, it is required to inform the parties when it will make the final decisions. Again, meeting in which the ARB meets to render its decision must be in an open session.[17]

If however the full ARB rejects the panel's decision, then a second panel must be composed of ARB members who did not hear the first protest hearing, if not available, then the full ARB may determine the protest. The ARB must notify the taxpayer of the new hearing in the same manner provided for the first ARB hearing.[18]

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[15] Ibid.

[16] "Rules and Administrative Procedures," 2001 Texas Property Tax Appraisal Review Board Manual, Texas Comptroller of Public Accounts.

[17] "Resolving Disputes and Approving Appraisal Records," 2001 Texas Property Tax Appraisal Review Board Manual, Texas Comptroller of Public Accounts.

[18] Ibid.

As stated, the ARB makes its decision after listening to both sides and can only make a determination based solely on the evidence presented at the hearing. At no point in time can a taxpayer contact any of the ARB members outside of the hearing. State law requires that ARB members sign an affidavit stating that they have not discussed the case with the taxpayer prior to the hearing. An ARB member who discuses a case with the taxpayer must remove himself or herself from that taxpayer's hearing. The members' behavior is not a matter taken lightly. There are various grounds upon which a member can even be removed from the ARB. Additionally, during this past legislative session, the Legislature provided the appraisal districts with two additional grounds for removal of an ARB member. An ARB member can now also be removed for taking part in *ex pate* communications regarding hearing procedures and for participating in an ARB determination in which the member had a conflict of interest or was related to a party in an ARB determination.[19]

District Court Review

Once the ARB rules on the taxpayer's protest, it is required to notify the taxpayer of its decision via certified mail. If the taxpayer is dissatisfied with the decision, the taxpayer still has the recourse of the state's court system by appealing to the state district court in their county of residence. The appeal must be filed, in the form of a petition for review, within 45 days of the date the taxpayer receives the ARB's order.[20]

However, while the appeal is pending, the taxpayer is required to make a partial payment of taxes. The taxpayer must pay either the lesser of the amount of taxes due on the portion of the taxable value not in dispute or the amount of taxes due on the property under which the order from the appeal is taken. If the taxpayer is unable to make this partial payment, then the taxpayer may ask the court to excuse them from prepaying the taxes. In order to do so, an oath of "inability to pay" the taxes in question must be filed with the court, and the taxpayer must argue that prepaying the taxes restrains their right to access the court on the protest. The court will then hold a hearing to decide the terms or conditions of the payment.

At the district court, instead of proceeding trial, the taxpayer may ask the court to have the appeal resolved through arbitration. If instead the parties proceed to trial, then the matter is reviewed *de novo*. Meaning the court will review all the pertinent information on the matter that is available from both sides instead of merely reviewing the record that was produced at the ARB. It is up to the district court's discretion to determine the amount of the award, meaning the court can also adjust the amount in dispute.

If a taxpayer is not successful in the appeal, they must pay the taxes in dispute (or any adjustment as determined by the court), and incur legal fees and court costs. However, if successful, sections

[19] "Chapter 6. Local Administration," 2001 Texas Property Law Changes, Texas Comptroller of Public Accounts, August 2001.

[20] "How to Protest Your Property Value for Property Taxes," Texas Property Taxpayers' Remedies, January 2002.

42.07 and 42.29 of the Tax Code allows for the district court's discretion to award part or all of the costs of the appeal, and the attorney's fees to the taxpayer.

RECOMMENDATION

The Ways and Means Committee makes the following findings and determinations:

- The overall system is fair. Moreover, there are presently no viable alternative to the current appeals process of appraised values for property tax purposes. Although there was much testimony during this past legislative session regarding abuses at the appraisal district level and of the unfairness with the appraisal review board, it was primarily anecdotal in nature and failed to reveal any widespread abuses. Although the committee is extremely concerned about the abuses which were expressed at the hearings, and without discounting the veracity of the testimony given by many of the concerned taxpayers, the committee finds that the testimony failed to show that there are any problems that are inherent with the current system.

- Additionally, throughout the committee's review of this issue, no valid alternatives were suggested or they were cost prohibitive. One suggestion was that an appeal from an ARB decision be pursued in a justice of the peace court instead of state district court. It was suggested that this was a viable alternative because of the decreased court costs to the taxpayer and of the simplicity of the system that allows for the taxpayer to appear *pro se*. However, after reviewing this option it is the committee's determination that pursuing an appeal in a justice of the peace court would not only not remedy any alleged inconsistencies and unfairness with the current system but would potentially create more problems. Among the concerns the committee has are issues of judicial inexperience, increased litigation, increased expenses, and of potentially biased outcomes in the proceedings. First, some of the issues involved in an appraisal of property can, although not always, become extremely complicated especially when dealing with business property. It is the committee's concern that a justice of the peace, who is not always a licensed attorney, may not have the expertise or experience to handle a potentially complicated case. Additionally, lower filing fees and a more informal process could prove to be an incentive for taxpayers to appeal, regardless of the merits of their case and thus open a potential flood gate of frivolous appeals. An increase in appeals would also increase the expenses to appraisal districts having to defend themselves, expense which is ultimately passed on to the taxpayer. Moreover, because the appraisal district could still appeal any loss to a county court at law, the taxpayer is still not avoiding the state court system and face the possibility of still losing and having to pay their taxes. Lastly, if a justice of the peace is to decide the outcome of these disputes, the matter becomes potentially too political since an elected official might have to rule against a taxpayers who is also a potential voter. This last scenario in particular is one of the concerns that was addressed and remedied during the Peveto reforms.
- Another alternative suggested was to allow the Office of Administrative Hearings to handle the appeals or to create a state appeals commission. It was suggested that hearing examiners or retired judges could travel the state hearing these appeals. A filing fee, to be payed by the taxpayer, would serve as a sort of user fee to offset some of the costs of this new alternative, and as a deterrent to frivolous appeals. Although no specific amount was suggested, it was noted that the fee could not be too high otherwise it would be an obstacle for the taxpayer if the amount in controversy was not very large. The concern to the committee is that although the fee

would cover some of the expenses, it would not cover the bulk of the expenses of these alternatives. The remainder of the expenses would be bourne by the appraisal district or directly by the state. The appraisal districts also suggested that in order for one of these alternative to be viable, the review accorded to an appeal must not be *de novo*, but only on the record developed at the ARB, otherwise this alternative would also encourage increased meritless appeals and increased administrative costs.

SCHOOL DISTRICT CHALLENGE

When a taxing unit files formal objections with the ARB regarding the appraisal records it is referred to as a challenge, whereas the taxpayer's hearing, as discussed in the previous section, is termed a protest. Unlike taxpayers, taxing units are more limited in the types of issues they can challenge. Additionally, taxing units cannot dispute the appraised value placed on a particular property for review. Taxing units however, may challenge for any of the following reasons:[21]

- the level of appraisal of any category of property or geographical area in the district (but not the appraised value of a single parcel of property);
- property left off the appraisal records for the unit or the district;
- a grant of an exemption; and
- a determination that land qualifies for special appraisals.

The impact of a taxing unit challenge can have a significant impact on the appraisal roll. If improper appraisal methods have affected a group of similar properties or a particular area, the taxing unit may challenge the district's overall appraisal level of that group or area. In a challenge hearing, if a taxing unit's evidence shows a group of properties is undervalued, then the ARB should direct the chief appraiser to reappraise each property within the category or within the specified territory.[22]

Taxing unit challenges are typically scheduled before taxpayer protests because challenges are rare and usually filed before the deadline for protests. A challenge must be filed by the taxing unit before June 1, or within 15 days after the chief appraiser submits the appraisal records, whichever is later. As for late challenges, the Tax Code is silent on the issue of late-filed challenges. The Comptroller's office has suggested that the ARB should, in order to resolve this gray area of the law, hear the challenge. The ARB might also best be able to resolve this matter if the taxing unit asks for the challenge before the ARB approves the appraisal records, shows a good reason for missing the deadline, and agrees to explain its reason in its challenge grounds.[23]

Once the challenge is received, the ARB must notify the taxing unit in writing of the date, time, and place of its challenge hearing. The notice is sent to the taxing unit via mail at least 10 days prior to

[21] "Resolving Disputes and Approving Appraisal Records," 2002 Texas Property Tax Appraisal Review Board Manual, Texas Comptroller of Public Accounts.

[22] Ibid.

[23] Ibid.

the hearing date. The ARB's shall also deliver notice of the date, time, and place for the challenge hearing to each taxing unit in which the property involved in the challenge is or may be taxable. Each taxing unit may appear to offer evidence or arguments.[24]

When the challenge includes property involving a taxable leasehold or other possessory interest in property owned by the state or a taxing unit, the state or unit shall also receive notice of the ARB hearing. The state or taxing unit may appear at the ARB hearing to offer evidence and arguments.[25]

If an ARB correction increases a property owner's tax liability, the affected owner must be sent a correction order and given 30 days from the date of mailing to file a protest and request a hearing.[26]

PROPERTY VALUE STUDY

As mentioned previously, the Property Value Study, (PVS), determines the distribution of state aid to public schools. The study compares appraised values estimated for tax purposes with independent estimate of market value based on either sales prices or independent appraisals. The procedures used are based on state law, agency rules, industry standards on ratio studies, and generally accepted appraisal and statistical methods. The purpose of the study is to ensure equality and uniformity of local appraisals so that each school district receives its rightful share of state revenue. However, the conflict occurs when the Comptroller's findings differ significantly from the local appraiser's valuation.

Although it is often referred to as the Property Value Study, in reality there are two annual studies that are conducted.

The first is required under Subchapter M, Sections 403.301-403.304, of the Government Code. This study is the more well known of the two and is what traditionally is referred to when discussing the Property Value Study. This study estimates taxable property values in each school district in the state and reviews the appraisal standards, procedures, and methodology used by each appraisal district. The study's findings are used to certify and, in some cases, adjust school-district property values that are then reported to the Texas Education Agency, (TEA). TEA uses these estimates of school district taxable values in determining the amount of state funds each district receives. Review of the appraisal methods, standards, and procedures used by each appraisal district is referred to as MSP reviews. The review results are communicated to the appraisal district and affected school districts so that the appraisal districts can use the review and improve their operations.[27]

[24] Ibid.

[25] Ibid.

[26] Ibid.

[27] Written testimony submitted by Tim Wooten of the Texas Comptroller of Public Accounts, Ways and Means Hearing, April 25, 2002.

The second study is required under section 5.10(a) of the Texas Property Tax Code. This study measures the level and uniformity of appraisals in each appraisal district. Under this authority, the Comptroller is also required to use the data from the school district study for the appraisal district study.[28]

The study is an ongoing process with each study beginning in January and ending in December of the study year. (See Appendix) The Government Code requires the Comptroller, through its Property Tax Division, (PTD), certify preliminary school district property wealth estimates by January 31 of the year following the study year and to certify final estimates in time for their use in school funding (normally, the following July 1). Thus as can be seen, dates are an important part of the formula TEA uses in calculating the state aid to local school districts.[29]

The data that forms the basis of the annual studies consist of property sales and appraisals selected in each of the state's 1,000 plus school districts. These selected properties are referred to as "samples".[30] The property categories among which these samples are discussed in the next section.

School Districts

The objective of the first this study is to estimate each school district's taxable wealth. The PTD may develop its own estimates of taxable value of a school district or instead may accept that school district's local estimates. The study analyses residential, commercial, agricultural, mineral, and utility properties. It does not analyze industrial property, intangible personal property, or special inventory, although the taxable values for those categories as reported by local county appraisal district's (CAD) are included in the estimates of total taxable value for school districts.[31]

The PTD develops the value estimates (or as mentioned above, accepts the local estimate) in 12 property categories in each school district and adds these individual property category estimates to produce an overall estimate of "market value" for the district. Next, the PTD staff deducts allowable exemptions and reductions from the market value estimates to generate the "taxable value" estimate for the district. It is then that this school district taxable wealth estimate is certified to the Texas Education Agency at the end of January each year. [32]

The PTD has grouped these 12 categories two broad groups: "local properties" and "technical properties." Local properties consists of single-family residences, multifamily residences, vacant

[28] Ibid.

[29] Ibid.

[30] Ibid.

[31] Patrick K. Graves, "Property Tax Appraisal: Issues and Responses," Focus Report, House Research Organization, August 5, 2002.

[32] Written testimony submitted by Tim Wooten, Property Tax Division, Texas Comptroller of Public Accounts, Ways and Means Hearing, April 25, 2002.

lots, rural acreage at market value, farm and ranch improvements, commercial real and personal property, mobile homes on leased land, and real property inventory. Technical properties consist of rural acreage at productivity value, minerals and utilities. Appraisal firms working under contract appraise the minerals, utilities and industrial property in most appraisal districts. There are some properties for which various reasons are not studied, such as industrial real and personal property, intangible personal property, and special inventory. However, any reported taxable value is included in a school district's estimate of total taxable value.[33]

How Category Property Value Estimates are Developed for the PVS [34]

- First, staff collects a random sample of sales and/or appraisals in each local and technical property category that has significant value in a school district. The sample data includes sale prices obtained from real estate multiple listing services, local deed transfer filings, property owner questionnaires, CADs, and other resources, plus estimates from PTD field appraisals.

- Second, in each property category, staff compares the total appraisal district value from the local tax roll to the total PTD value for sampled property and computes a weighted mean ratio. The appraisal district value is the value assigned to the property by the appraisal district. The PTD value consists of either the sale price (adjusted when necessary) or the PTD staff appraisal. The weighted mean ratio is the percentage of market value indicated by the sample.

- Third, the weighted mean ratio is divided into the total value reported for the category by the appraisal district to produce the PTD's estimate of value for the category.

By adding the category estimates, an overall estimate of school district's market value is reached. Then by subtracting any allowable exemptions and reductions from that total results in a district's estimated taxable value.[35]

School districts or their appraisal districts report appraisal roll value totals. These totals are important to the successful completion of the study because, they are used as the basis for the PTD category estimates. They are either accepted, if the total value for tested property categories is within a margin of error, usually no less than 5%; or they are adjusted by the appropriate weighted mean ratios and certified to the TEA. If accepted, the Comptroller is said to certify "local value." If adjusted, the Comptroller is said to certify "state value." [36]

As stated earlier, conflict occurs when the state's values differ significantly from the local values, especially if state values are higher than local values, which they generally are. It is school districts

[33] Ibid.

[34] Ibid.

[35] Ibid.

[36] Patrick K. Graves, "Property Tax Appraisal: Issues and Responses," Focus Report, House Research Organization, August 5, 2002.

that are often the most vocal when there is a variance in the two appraisals. If the values are too low, school districts will lose state funding and thus must make up for the shortfall by reducing spending or increasing local tax rates. Additionally, the school district receives less local property tax revenue than it would have received if it taxed its property at the same rate on the basis of PVS value. Again, when facing a budget deficit these school districts are forced to either reduce programs or increase tax rates.[37]

Review of Appraisal Districts

The Comptroller is required under Section 5.10 of the Property Tax Code to conduct an annual study of appraisal districts to determine the median level of appraisal and the uniformity of appraisal for each major property category for each appraisal district in the state. By law the Comptroller is required to use the annually collected school district data to perform this part of the study.[38] The PTD staff uses the school district data aggregated to the appraisal district level, and thus measures each appraisal district's level of and uniformity of appraisal. The level of appraisal refers to how close to full market value an appraisal district appraises typical properties. The level of uniformity refers to how widely appraisals vary within and across the categories mentioned above. In order to determine the level of appraisal and uniformity, the PTD staff compiles and analyzes five separate appraisal district performance measures:[39]

- a median;
- a coefficient of dispersion;
- the percentage of sample parcels with 10% of the median;
- the percentage of sample parcels within 25 % of the median; and
- a price-related differential.

The median is an indication of the overall level of appraisal in a district. The coefficient of dispersion is a measure of appraisal uniformity, showing how closely the sample ratios are clustered about the median. The price-related differential is a measure of difference in the appraisal of low-value and high-value properties.[40]

The data used to complete these performance measure are the school district study data aggregated to the appraisal district level. What that means is that if there are three school districts in a particular appraisal district, the PTD will combine the study data used to compute value estimates in these three school districts, and thus will compute the performance measures from these aggregated data.[41]

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[37] Ibid.

[38] Written testimony submitted by Tim Wooten, Property Tax Division, Texas Comptroller of Public Accounts, Ways and Means Hearing, April 25, 2002.

[39] Ibid.

[40] Ibid.

[41] Ibid.

The preliminary study is published at the end of January each year, and the final study is published around July first. Both the preliminary data and final reports of the PTD's School and Appraisal Districts' Property Value Study contain the five performance measures previously described, along with the detailed definitions of the measures. These publications also contain explanations of the methods used by PTD staff to develop the measures.[42]

As mentioned previously, the PTD's also reviews the appraisal methods, standards, and procedures used by each appraisal district, referred to MSP reviews. This review also begins each January. Each appraisal district receives a questionnaire covering exemptions documentation, appraisal manuals, internal controls, use of sale prices, and programs designed to improve appraisers' performance. The PTD uses the reviews findings to deal with any problems that may be occurring at an appraisal district. The review results are communicated to the appraisal district and affected school districts so that the appraisal districts can use the review and improve their operations. Appraisal districts may respond to any of the recommendations made by the PTD. This process ends in December.

Appeals of PVS

The law gives school districts and some property owners the right to appeal or protest the PTD's preliminary findings of taxable property value certified to the TEA. Property owners may protest if their property is used in a prior-year school district study and the total tax liability on all the owner's property in the school district's category sample is $100,000 or more.[43]

As mentioned above, school districts are very vocal about complaints regarding the PVS. Approximately 1/4 to 1/3 of all school districts appeal the PVS findings in any given year. Of these appeals about 80% of the appeals are settled informally prior to any administrative hearing. Most of the appeals have come from low property wealth school districts that receive additional state aid under Chapter 42 of the Education Code. These school districts receive less aid than they would receive if the TEA used local values versus the state values. These districts are in a sense forced to appeal because they have either a small base or approaching the state's tax rate cap.[44]

Comptroller rule allows appraisal districts to protest appraisal performance measures in the same way that school districts protest preliminary value findings.

Petitioners have 40 days after preliminary findings are certified to file a protest. This deadline occurs in about mid-March each year. The protests are first dealt with informally. PTD staff researches these appeals or protests, corrects any clerical error in the data, and may recommend any necessary adjustment. If however a petitioner disagrees with these recommendations, a meeting

[42] Ibid.

[43] Ibid.

[44] Patrick K. Graves, "Property Tax Appraisal: Issues and Responses," Focus Report, House Research Organization, August 5, 2002.

with the staff in an informal conference occurs. Usually most challenges are resolved at this stage. If a petitioner is still dissatisfied with the results, a petitioner can seek a formal hearing before the Comptroller's hearing examiners. These hearings occur usually in early May. Comptroller rules combine school district, taxpayer, and appraisal district protests, from the same appraisal district, into a single hearing. At the conclusion of the hearing, examiners issue written decisions which either party may take exception to in writing. After considering all submitted written exceptions, examiners issue final decisions.[45]

Any protests filed by school districts must be heard and final value decisions made by July 1, in time for the TEA to use the findings to distribute state education funds. After receiving the examiners' final decision, the PTD staff modifies the study finds accordingly and prepares the findings for certification. Any further appeal from these findings is limited by law, solely to school districts who may do so to district court. Other parties' protests, however, can affect a school district's values even if the district does not appeal.[46]

MANDATORY RENDITION AND MANDATORY SALES DISCLOSURE

In the course of this committee's hearings, when discussing local property tax appraisals and the property value study, and during the hearings of the Select Committee of School Finance, the issue of mandatory rendition of business personal property and mandatory sales disclosure was raised. The PTD as stated, is responsible for testing the values determined by the appraisal districts in determining state aid to school districts and in insuring that the appraisal districts are valuing property at the correct level. Since the PTD often relies on the data obtained from the local appraisal districts, an accurate assessment by the appraisal districts is necessary in order to avoid a considerable loss of value from the appraisal rolls.

MANDATORY RENDITION

Section 22.01 of the Tax Code, requires a person to render for taxation all personal property used for income-producing business. To render means to report the information to the local county appraisal district. However, in absence of any penalty provision for noncompliance, enforcement has been rare.[47]

Appraisal district claim that businesses' disregard for the law, by failing to turn over inventory lists of their business personal property, could be denying taxing entities millions of dollars in revenue. The Comptroller's 2001 Preliminary Property Value Study indicates a value of $85,597,975,452 for business personal property. Some appraisal districts argue that based on their experience and audits conducted in Dallas, Houston, and Austin, this figure is under reported by up to 30% or $36.6

[45] Ibid.

[46] Ibid.

[47] Patrick K Graves, "Property Tax Appraisal: Issues and Responses," Focus Report, House Research Organization, August 5, 2002.

billion.[48] According to Jim Robinson, chief appraiser of the Harris County Appraisal District, evasion might be even as high as 70%.

Appraisal districts note that by failing to render business personal property, the tax burden has shifted to residential taxpayers, and other businesses that do render personal property as required by the statute.[49] Additionally, appraisal districts have maintained that those business that fail to render also receive an unfair competitive advantage.[50] In the absence of a penalty provision, some appraisal districts have begun to try to force renditions by valuing un-rendered property extremely high in order to get the necessary information through the appeals process.[51] They claim however that this is not a reliable alternative because of limited resources. Additionally, appraisal districts argue that in having to estimate values, they often end up with inaccurate appraisals.

However the appraisal districts recently claimed a legal victory when the rendition statute was upheld as mandatory and judicially enforceable, despite the lack of penalties, by the First Court of Appeals in Houston. That court ruled that an appraisal district could seek court orders compelling businesses to render their personal property. *Robinson v. Budget Rent-A-Car Systems, Incl, et al.*, 51 S.W.3d 425 (2001, Tex. App.) However, since the Texas Supreme Court declined to hear the case, the opinion's authority does not extend beyond the jurisdiction of the appellate court.[52]

The Harris County Appraisal District has taken advantage of this recent decision, and with the cooperation of the Harris County Attorney's Office, they have begun pursing renditions from almost 4,000 businesses that have not rendered in the past three years and that have an estimated tax liability on their personal property of at least $100,000.[53] They maintain however, that although they are pursuing this available alternative, they consider it an extremely costly and unreliable

[48] Testimony by Metropolitan Council of Appraisal Districts, Select Committee on School Finance, December 6, 2002.

[49] Testimony of Jim Robinson, Harris County Appraisal District, Ways and Means Committee, April 24, 2002.

[50] Ibid.

[51] Letter to Representative Rene Oliveira, Member of Select Committee on School Finance, from Art Cory, Chief Appraiser, Travis Central Appraisal District, March 13, 2002.

[52] Patrick K Graves, "Property Tax Appraisal: Issues and Responses," Focus Report, House Research Organization, August 5, 2002.

[53] Ibid.

alternative.[54]

Appraisers seek broader auditing authority in order to pinpoint businesses that do not disclose all their taxable property, particularly those businesses that maintain large inventories. Although no specific alternative was suggested, the appraisal districts argue that stronger rendition laws are necessary in order to add considerable value to the appraisal role.

RECOMMENDATION

The Ways and Means Committee recommends to the 78th Legislature:

- Evaluate how much value is lost to the appraisal roles due to a lack of business personal property rendition.
- Evaluate what mechanisms are available to the appraisal districts and to businesses, in order to ensure a more accurate appraisal of business personal property.

MANDATORY SALES DISCLOSURE

For some time appraisal districts have sought to establish mandatory disclosure of sales prices for real property. The appraisal districts have long argued that not knowing how much buyers pay for property greatly inhibits their ability to appraise the property at full market value. They maintain that a sale is the most accurate evidence of the market value of property, and of properties comparable to the one sold.[55]

However some realtors and commercial businesses oppose mandatory disclosure as a violation of a property owners' privacy. They allege that mandatory disclosure could result in disclosing information about products or processes that could put some business property owners at a disadvantage with their competitors. They also contend that sales prices can be misleading because they are often influenced by non-market factors not readily apparent without comprehensive analysis.[56]

In addressing these privacy rights concerns, some appraisal districts suggest that the sale be filed with the deed, but that the sale be protected through specified confidentiality.

[54] Testimony of Jim Robinson, Harris County Appraisal District, Ways and Means Committee, April 24, 2002.

[55] Patrick K Graves, "Property Tax Appraisal: Issues and Responses," Focus Report, House Research Organization, August 5, 2002.

[56] Ibid.

In an absence of mandatory sales disclosure, appraisal districts maintain that they presently resort to inefficient methods in order to obtain sales. Among the methods provided is the reply of letters the appraisal districts send to new homeowners asking for information regarding the sale price of their home.[57] The appraisal districts are able to inquire to new homeowners because of deed transactions. According to the appraisal district this method is unreliable because only about 20% of the homeowners respond, and there is no way to verify the information provided.[58] Another method employed is the inflation of the appraisal value of the property sold, in order to force a protest by the taxpayer.[59] Appraisal districts argue however that taxpayers often fail to protest and are consequently are taxed at a higher amount than the market value of their property.

RECOMMENDATION

The Ways and Means Committee recommends to the 78th Legislature:

- Consider making the sales price disclosure to appraisal districts mandatory.
  If the legislature adopts such a measure however, it shall include provisions to protect the privacy of the measure to the taxpayer. For example, allow the sale price to be used only at a protest hearing to show a taxpayer the specific sales used to value their property.

[57] Letter to Representative Rene Oliveira, Member of Select Committee on School Finance, from Art Cory, Chief Appraiser, Travis Central Appraisal District, March 13, 2002.

[58] Ibid.

[59] Ibid.

Appendix

Property Value Study Time Line

January 1
Appraisal date for each study. Property Tax Division makes appraisals, the property value is estimated as of January 1. When necessary, sales are adjusted for sale dates that occur before or after January 1. January is an important month in the study because it signifies the conclusion of one study (except for appeals) and the beginning of the next study.

January 31
Studies are mailed to school districts and certified to Texas Education Agency, (TEA), on the last

working day of January each year.

February
Staff receive sample requirements and begins gathering the sales and appraisal information necessary to perform the current-year study in each school district. This continues until the study is released the following January.

March 12
The deadline for appeals of the prior-year study falls approximately on this day each year. Staff researches appeals and writes recommendations for study adjustments. Recommendations are mailed to appellants who may agree or disagree with PTD staff's recommendations.

May 1-5
Informal conferences are usually held during the first week of May. If appellants disagree with appeal recommendations, informal conferences are held to try to resolve or narrow the issues.

May 8-12
Formal appeal hearings are usually held during the second week of May. If appellants are not satisfied with the outcome of informal conferences, they may appear at the formal hearings before a Comptroller hearing examiner.

May 15-31
The hearing examiner issues written decisions based on formal appeal hearings. Decisions are delivered to the PTD and mailed to protesting parties. If appellants or PTD staff disagrees with the hearing examiner's decisions, exceptions are written by PTD staff and/or received from protesting parties. PTD files replies to protesting parties' exceptions.

June
The hearing examiner issues final decisions after considering written exceptions submitted by protesting parties or PTD staff. PTD staff applies changes to study findings as directed by the hearing examiner, prepares findings for final certification and submits them to the Comptroller for approval.

July 1
Final results of the study are certified to the Commissioner of Education.

July-December
Research, analysis, and review of the current-year study continues through the end of December and into January. As appraisal district field-work is completed staff sends reports to appraisal district to identify and correct clerical errors. Staff mails appraisals of oil and gas and utilities to appraisal firms and taxpayers for review and comments. Preliminary values are compiled for certification to TEA on January 31.

CHARGE 2

Review the dedicated uses of the additional municipal sales and use tax, sales and use taxes imposed under Chapter 451-453 of the Transportation Code, sales and use taxes for special purpose taxing authorities, county sales and use taxes, county health services sales and use tax, and county sales and use tax for landfill and criminal detention centers, and municipal and county hotel occupancy taxes.

Assess the impact such taxes have on the ability of communities to respond to changes in demand for and use of governmental services.

BACKGROUND

The State of Texas allows for the imposition of various types of sales and use taxes by local governments. Among the various entities that are authorized to impose these taxes are cities, counties, economic development corporations, metropolitan transit authorities, hospital districts, library districts, and crime control and prevention districts, among others. (See Appendix)

There are differences in the way these various taxes are adopted, administered, and the rates at which they can be adopted, increased or decreased. For example, different rates apply depending on the governmental entity imposing the tax, the city rate is 1/4% to 2%, the county rate is ½% to 1%, the mass transit authority, and the city transit department rate is 1/4 % to 1%. The range of tax imposed is also dependent on what the local tax rate is in the jurisdiction of the local government. The most marked difference however, is obviously the purpose for which the tax revenue is dedicated. Below is a summary of the current state of each of the different local sales and use taxes imposed in Texas.

ECONOMIC DEVELOPMENT SALES TAX[60]

History of the Economic Development Sales Tax
Prior to 1979, there were few statutory provisions allowing for the promotion of economic development. Business leaders expressed this concern to the Texas Legislature and asked for authorization to create an entity that could encourage the development of new local commerce.

In response, the Legislature passed the Development Corporation Act of 1979, ("the Act"). The Act allows cities to create nonprofit corporations to attract businesses and create job opportunities. The Act allows eligible cities the option of adopting dedicated sales and use tax to promote the creation of new and expanded industry and manufacturing activity within the municipality and its vicinity. The authority to enact the sales and use tax for economic development is found in Texas Civil Statutes Article 5190.6. The development corporations operate separately from the municipalities, with boards of directors overseeing their efforts.

However, prior to 1987, these entities were primarily dependent on funding from private sources. At that time, development corporations could not legally receive funding from the state or local governments because of a constitutional prohibition against the expenditure of public funds to promote private business activity. In 1987, the voters approved an amendment to the Texas Constitution which provided that expenditures for economic development serve a public purpose and therefore permitted under Texas law. The Legislature during subsequent sessions passed

[60] This summary is taken from "Using Sales Tax to Promote Economic Development," 2002 Handbook on Economic Development Laws for Texas Cities, Volume I, Office of the Attorney General, State of Texas (this publication is considered the definitive work on Section 4A and Section 4B Economic Development Corporations and has thus been heavily relied upon); and "Economic Development Sales Tax", Texas Comptroller of Public Accounts, October 2001.

further laws that would allow state and local government funds to be used to promote economic development.

In 1989, the Legislature amended the Act by adding Section 4A, which allowed the creation of a new type of development corporation. The legislation provided that a Section 4A development corporation could be funded by the imposition of a local sales and use tax dedicated to economic development. The tax could be levied only after its approval by the voters of the city at an election on the issue. Proceeds of the sales tax were dedicated by statute to economic development projects to primarily promote new and expanded industrial and manufacturing activities.

In the 1991 legislative session, the Legislature authorized another type development corporation and the imposition of a new sales tax, a Section 4B sales tax. This legislation authorized a greater use of the sales tax revenue, allowing them to be used by certain cities to promote a wide range of civic and commercial projects.

The popularity of the Section 4B sales tax led the Legislature in 1993 to broaden its availability to any city that was eligible to adopt a Section 4A sales tax. Thus, most cities in a county of under 500,000 could adopt either a Section 4A or Section 4B sales tax if they had room in their local sales tax.

In 1997, the Legislature took another step to providing further flexibility in the use of sales tax revenues by authorizing Section 4A corporations to undertake a project currently eligible under Section 4B but not Section 4A. Thus, a Section 4A corporation is able to undertake a Section 4B project without having to switch to a Section 4B corporation. The city however must obtain voter approval before they can do this.

In 1999, the Legislature made further expansions to the allowable uses of economic development sales tax revenue by adding job training, targeted infrastructure, job creation and retention and education facilities to the definition of "project".

The result has been that since 1989, the use of sales tax revenue for economic development has become the most popular vehicle by which cities can promote economic development. Since then the over 475 cities have adopted this tax and have cumulatively raised more than $241 million dollars annually in additional sales tax revenue dedicated to the promotion of local economic development. Of these cities, 126 adopted a Section 4A economic development sales tax, 275 cities have adopted a Section 4B economic development sales tax, and 74 cities have adopted both a Section 4A and a Section 4B sales tax. (See Appendix)

How Cities Have Used the Sales Tax for Economic Development

There are a number of ways in which Texas cities are expanding the proceeds from their sales tax

for economic development.[61] Among the more popular uses are the following:

- Business Attraction: advertising, promotion, image marketing, marketing contracts with chambers of commerce or industrial foundations, travel and related expenses, trade show participation, highway signs and billboards, direct mail, newsletters, video brochures.

- Incentives to Businesses: revolving loan funds, loan guarantees, loan or interest forgiveness or write-down, business incubator programs and assistance in enterprise zone establishment, capital grants, relocation and moving expense grants, rent subsidies, incentives for certain prison or correctional facilities, grants for land purchase, operating costs grants, equipment purchase grants, loan guarantee for state programs, subordinate loans to financial institutions.
- Land and Building Purchase, Lease, and Upgrade: land purchases for industrial parks, building purchases for business incubators and/or day care centers, access upgrades or placements, land to expand airports, expansions and upgrades of existing buildings, construction of buildings, land purchase for resale or lease, construction of speculative buildings.

- Infrastructural Upgrade and Placement Related to Commercial Areas: infrastructural upgrades or placements for commercial or industrial areas, water and sewer line extensions to industrial parks, drainage projects, odor control projects, engineering and construction of needed bridges, and rail spurs for industry.

- Training and Education: job training geared for specific companies, assistance in building state technical colleges, purchasing computer equipment for vocational training programs, seeking JTPA supplemental funding, informing prospects about small business development centers and work force development resources.

According to the Attorney General's Office, the above listed expenditures have not been reviewed for legality under the Act. Their advice is that prior to implementation of any program, a local economic development corporation should carefully review the relevant portions of the Act in order to determine whether the planned expenditure is authorized. Further, they also note that the Act does not authorize unqualified donations of public funds. Rather, any grant of sales and use tax monies must "be made under contractual or other arrangement sufficient to ensure that the funds granted are actually used in furtherance of the purposes of the act"

Differences and Similarities Between Section 4A and the Section 4B Sales Tax

Although there is much similarity between the Section 4A and Section 4B tax, there are a number of marked differences that distinguished the two, primarily: the authorized uses of the tax proceeds, the oversight procedures regarding project expenditures, and the means for adopting and altering the

[61] According to the Attorney General's publication, this information is derived from a survey performed by Bill R. Shelton of The Cornerstone Group and published in the Texas Town & City Magazine.

tax by election.

Eligibility To Adopt The Tax

Section 4A
A city is eligible to adopt the Section 4A tax, with voter approval, if the new combined local sales tax rate would not exceed 2% and:

- the city is located in a county with a population of under 500,000; or
- the city has a population of less than 50,000 and is located within two or more counties, one of which is Bexar, Dallas, El Paso, Harris, Tarrant or Travis County; or
- the city is under 50,000 population and is within the San Antonio or Dallas Rapid Transit Authority territorial limits, but has not elected to become part of the transit authority.

Section 4B
A city may impose the Section 4B tax, with voter approval, if the new combined local sales tax rate also would not exceed 2% and if the city fits into one of the following categories:

- the city would be eligible to adopt a Section 4A sales tax; or
- the city is located in a county with a population of 500,000 or more and the current combined sales tax rate does not exceed 8.25% at the time the Section 4B tax is proposed; or
- the city has a population of 400,000 or more and is located in more than one county, and the combined state and local sales tax rate does not exceed 8.25%.

In both cases, participation in a rapid transit authority does not invalidate a city's ability to adopt either a Section 4A or Section 4B tax if adoption of the tax would not place the city above its statutory cap for the local sales tax rate. The proposed a tax rate must also equal to 1/8, 1/4, 3/8, or ½ of 1 % for both taxes.

Adopting and Altering the Tax
There are some marked differences in how Section 4A and Section 4B taxes may be created or altered by election. A Section 4A tax is authorized by an election that has mandatory statutory wording for the ballot proposition. There is also authority for a Section 4A tax to be adopted in conjunction with a sales tax for property tax relief under one combined proposition at the same election. Once adopted, the Section 4A tax continues in existence until repealed by the voters. The Section 4A tax can be increased, reduced, or repealed at subsequent elections within the statutory range provided for the tax

The Section 4B tax has no required statutory wording for the ballot proposition. It can be adopted by a general ballot proposition proposing the adoption of a Section 4B sales tax for economic development. However, cities do often place a list of the authorized categories for expenditure in the ballot wording that adopts the Section 4B tax. There is no authorization for a Section 4B tax to be combined onto one ballot proposition with a sales tax for property tax relief. If the voters want

both taxes, they must approve the items as separate ballot propositions. Similarly, there is no authorization for a Section 4B tax rate to be increased or reduced at subsequent elections. For Section 4B corporations created prior to September 1, 1999, the Section 4B tax arguably only ends once the bonds and any other debt obligations have been paid in full for all of the projects undertaken by the corporation. For corporations created on or after September 1, 1999, the Section 4B corporation may also be dissolved by petition of the voters and an election on the issue. In either case, the 4B tax would continue until the prior debt obligations of the 4B corporation have been paid in full.

Use Of The Revenue

The Section 4A tax is the more restrictive of the two taxes in terms of authorized types of expenditures. The types of projects permitted under Section 4A are primarily more traditional types of economic development initiatives that facilitate manufacturing and industrial activity. For example, the Section 4A tax can be used to fund the provision of land, buildings, and equipment for projects such as industrial and manufacturing facilities, distribution and warehouse facilities, business related airports, port related facilities, recycling facilities, and closed or realigned military bases. The 4A tax can also be expended to promote new and expanded business development, facilities to promote job creation and retention, and certain educational facilities in use by institutions of higher education, and expenditures that promote new and expanded business development. Additionally, as of September 1, 2001, the Section 4A tax can also be expended for research and development facilities.

The Section 4B tax also allows expenditures that promote manufacturing, industrial, and commercial or retail operations. However, the 4B tax allows cities a wider range of uses for tax revenues such as projects that are typically considered community development initiatives. For example, authorized categories under Section 4B include, among other items, land, buildings, or equipment for professional and amateur sports facilities, park facilities and events, entertainment and tourist facilities, and affordable housing. As of September 1, 2001, the Section 4B tax may also be expended for research and development facilities, as well as for the development of water supply facilities or water conservation programs.

Use of Funds for Job Training

Prior to September 1, 1999, the statutory definition of the term "project" in the Act provided that Section 4A and Section 4B monies could be used only for land, buildings, equipment, facilities, and improvements or for certain costs directly related to these items. The 76th Legislature expanded the definition of "project" to allow the use of funds for job training, subject to four statutory limitations. First, tax funds cannot pay for more than one-half the actual cost of any job training. Second, monies may generally be spent for job training offered through a business enterprise only if the business enterprise has committed in writing to create new job that pay at least the average weekly wage for the county in which the jobs are to be located. Third, tax revenue may not be spent for job training if other state or federal funds dedicated to job training are used in the project. Fourth, the job training must be required or suitable for the promotion of development and expansion of

business enterprises and other enterprises described in the Act. There are however statutory exceptions for counties where the unemployment rate for the preceding calendar year is 1.5 times the state average or more.

Use of Section 4A Tax for Section 4B Projects

In 1997, the Legislature amended the Act to allow the voters of an area to approve at an election the use of Section 4A sales tax monies for a project authorized under Section 4B. This alternative allows cities with a Section 4A tax to propose Section 4B projects to the voters without having to both repeal or reduce the Section 4A tax and adopt a 4B tax.

If the city already has a Section 4A tax, it only needs to have the voters approve at the election the use of Section 4A tax proceeds for a particular 4B project or a category of 4B projects. The city would need to list each project or category of projects on a separate ballot proposition for the voters' approval. The voters would either approve or deny each proposition on its own merits.

The law requires that a specific 4B project or category of projects be clearly described on the ballot. The ballot proposition must be clear enough for the voters to discern the limits of the specific project or category of projects to be authorized. Additionally, if 4A monies are to be used to pay maintenance and operating of a 4B project, then the ballot proposition must state that fact.

A city may ask the voters to consider the use of 4A funds for a 4B purpose at the same election in which the voters are considering the creation of the 4A tax itself. A city may also have the voters consider authorizing the use of 4A funds for several different 4B projects or categories of projects at the same election. Additionally, even when undertaking a properly authorized 4B project, a 4A corporation is governed by all the normal rules applicable to 4A corporations.

Combined Proposition to Reduce a Section 4A Tax and Adopt a Section 4B Tax

As of September 1, 1999, a city may offer a combined ballot proposition that would reduce or abolish and existing Section 4A tax and at the same time approve the creation of a Section 4B tax. A city can now have the voters approve or reject both items together by one "yes" or "no" vote. However, a city is not required to combine these two issues into one ballot proposition. There is no statutory language required for this type of ballot under the Act. A city can still chose to have the voters repeal or reduce a Section 4A tax and adopt a Section 4B tax on separate ballots if they so choose to.

Use of Tax for "Sports Venue" Facilities

Section 4A

The 1997 legislative change that allows Section 4A corporations to undertake Section 4B projects, with voter approval, also allow cities to propose the use of Section 4A proceeds for a sports venue facility. A sports venue facility would be another type of Section 4B project that the city could ask the voters to approve as a separate ballot at a special election. A project qualifies as a "sports venue" if it is an arena, coliseum, stadium, or other type of area or facility that meets both of the following criteria:

- the primary use or primary planned use is for one or more professional or amateur sports or athletics events, and
- a fee for admission to the sports or athletics events is charged or is planned to be charged, except that a fee need not be charged for occasional civic, charitable, or promotional events.

State law specifies that any money authorized by the voters to be spent on a "sports venue and related infrastructure" may be spent on any on-site or off-site improvements that relate to a sports venue and that enhance the use, value, or appeal of the sports venue, including areas adjacent to it. Eligible expenditures would include any costs that are reasonably necessary to construct, improve, renovate, or expand the sports venue. The law specifically lists the following uses as examples of permissible "related infrastructure": stores, restaurants, concessions, on-site hotels, parking facilities, area transportation facilities, roads, water or sewer facilities, parks, and environmental mediation. Each of the facilities must however, relate to and enhance the sports venue.

Section 4B
As noted previously, section 4B tax monies may be used to fund projects relating to professional and amateur athletic facilities. A facility qualifies as a "sports venue" if it is an arena, coliseum, stadium, or other type of area or facility that meets all of the same criteria as in Section 4A corporations.

A city may submit to its voters a ballot proposition that would authorize the use of section 4B tax monies for a specific sports venue project or category of projects, including any infrastructure related to that project or category. Such a ballot proposition could contain language enabling the 4B corporation to use any section

The law requires that a specific sports venue project or category of projects be clearly described on the ballot. The description must be clear enough for the voters to discern the limits of the specific project or category of projects to be authorized. Additionally, if 4B monies are to be used to pay the maintenance and operating costs (and not just initial construction cost, etc.) of a sports venue project, then the ballot proposition must state that fact.

A city may have the voters consider the use of 4B funds for a sports venue at the same election in which the voters are considering the creation of the 4B tax itself. Also, a city could possibly have the voters consider authorizing the use of 4B funds for several different sports venue projects or categories of projects at the same election. However, the initial authorization of the Section 4B tax would be considered by the voters as a separate ballot proposition. Similarly, any sports venue project must be considered by the voters as a separate ballot proposition.

Promotional Expenses and Prior Debts
Section 4A
Section 4A(b)(1) limits Section 4A corporations to spending no more than 10% of the corporate revenues for promotional purposes. The Act does not define the term "promotional purposes." It would appear reasonable to include expenditures for advertising, attendance at trade shows, and the

costs of other promotional events or efforts within the 10% "promotions" limit. The Act, however, appears to distinguish between administrative expenses, for which there is no maximum level for expenditure, and promotional expenses, which are limited to no more than 10% of corporate revenues.

A Section 4A corporation is prohibited from assuming a debt or paying the principal or interest on a debt if the debt existed before the date when the city created the development corporation. This prohibition is contained in Section 4A(q) of the Act. This limitation does not prevent a corporation from undertaking or making future expenditures toward a project that is already in operation.

A Section 4A corporation may issue bonds, notes, and other contractual obligations to fund its projects. The tax proceeds received by the corporation may be used to pay the principal and interest on the bonds and any other costs related to the bonds. An example given by the Attorney General's Office in Letter Opinion 92-86, concludes that a development corporation may finance bonds for the start-up costs of a technical college if the funds are used solely for vocational training purposes. Any bond or debt instrument of the corporation remains an obligation of the corporation is not an obligation of the city nor backed by the city ad valorem tax rate.

Section 4B
During the 2001 Legislative session, the Legislature clarified the use of Section 4B proceeds for promotional expenses. Now, Section 4B(b) also limits Section 4B corporations to spending no more than 10% of the corporate revenues for promotional purposes. Again, the Act does not define the term "promotional purposes." The Act does however distinguish between administrative expenses, for which there is no maximum level for expenditure, and promotional expenses, which are limited to no more than 10% of corporate revenues.

The Section 4B corporation may also issue bonds, notes, and other contractual obligations to fund its projects. Prior to September 1, 2001, a Section 4B corporation's bond and other obligations could not exceed $135 million. This limitation was removed in the 77th legislative session. Further, a bond or debt instrument of the corporation is not an obligation of the city, nor is it backed by the city ad valorem tax rate. The tax proceeds received by the Section 4B corporation may be used to pay the principal and interest on the bonds and any other related costs. The legislature has not addressed whether a Section 4B development corporation is prohibited from paying principal or interest on a debt if the debt existed before the date the city created the Section 4B corporation.

Oversight Of Corporations

Section 21 of the Act provides that the city shall approve all programs and expenditures of both types the development corporations and shall annually review any financial statements of the corporation.
Additionally, Sections 23(a)(12) and 23(11)of the Act states that the powers of the corporation shall be subject at all times to the control of the city's governing body.

Although both Section 4A and Section 4B monies are overseen by the development corporation's board of directors and by the city council, they differ in the composition and in the length of a member's term. In pursuing a new project, under either Section 4A and Section 4B, corporations are required to obtain city council approval. However, Section 4B corporations are subject to additional procedural requirements. They must provide public notice and hold a public hearing prior to pursuing a project, and the public has 60 days to petition for an election to be called on whether to pursue the project.

Projects Located Outside of the City

Section 23 (a) (1) of the Act provides that both Section 4A and Section 4B economic development corporation may undertake projects outside of the city limits with permission of the governing body that has jurisdiction over the property. The language of the Act, however, does not seem to require approval if the project is located at least partially within the boundaries of the city. If the project is located completely within the jurisdiction of another municipality, the city would need approval of the city council for that municipality.

Administrative Expenses

Section 2(4) of the Act also states that the cost of a, Section 4A or 4B, project may include the administrative expenses and other expenses that are incident to placing a project into operation. The law states that these expenses could include administrative expenses for the acquisition, construction, improvement, and financing of any project. It is this authority that may be cited for the hiring of administrative staff to implement the work of the development corporation with regard to its projects.

Section 4A

Section 4A(b)(1) specifically permits a Section 4A corporation to contract with other private corporations to carry out industrial development programs. Section 4A corporations also have statutory authority to spend Section 4A sales tax money on maintenance and operation expenses for a 4A project. However, as with a Section 4B corporation, voters will be able to petition for an election on the issue of whether to prohibit the 4A corporation from expending 4A money for the maintenance and operation costs of a particular project.

Section 4B

Section 4B(a-2) states that the costs of a publicly-owned and operated project may include the maintenance and operating costs for the project. The Act, however, allows the voters to object to such an expenditure by submitting a petition of 10% of the registered voters of the city. Cities that are aware that they want to use Section 4B tax proceeds to pay the maintenance and operating costs of projects would be well advised to list this type of expenditure on the ballot when the Section 4B tax is first considered by the voters. By including this provision in the original ballot proposition, the city can assert that the public has already approved this type of expenditure at a prior election. Accordingly, if the city uses such a ballot provision, it cannot be required to hold an additional election even if a petition is submitted regarding these costs.

Allocation of Tax Proceeds
Once the sales tax is effective, either a Section 4A or 4B tax, the Comptroller remits the sales tax proceeds from the increase in the rate to the municipality with its other local sales tax proceeds. The Municipal Sales and Use Tax Act (Chapter 321 of the Tax Code) governs the imposition, computation, administration, and use of the tax, except where it is inconsistent with the Act. The city, upon receiving its local sales tax allotment from the Comptroller, must remit any sales tax for economic development to the industrial development corporation responsible for administering the tax. However, the proceeds of a sales tax for property tax relief, if adopted, would remain with the city.

There are other marked differences in the imposition and use of Section 4A and Section 4B sales taxes.

Section 4A
Required Ballot Wording for Section 4A Ballot
There is a statutorily required wording for a Section 4A sales tax proposition ballot. The actual wording used on the ballot must indicate what rate is proposed for the Section 4A sales tax.

Limited Time Period for the Tax
A Section 4A tax that is approved without a time limit is effective until repealed by election. However, a city may include in the wording of the ballot proposition a limitation on the length of time in years that a tax may be imposed. Once a limit is approved by the voters, the tax may only be extended beyond this time limit or reimposed if the city has an election at which the voters authorize the extension or reimposition of the tax. The actual wording used on the ballot must indicate what rate is proposed for the tax and the number of years the tax would be in effect.

Limiting the Types of Projects for a Tax
On a ballot to adopt, increase, or reduce the Section 4A tax, a city may also limit the use of the tax to a specific project. For example, a city could limit the use of the Section 4A tax to a project for a specific manufacturing entity or to a specific type of project such as expenditures for an industrial park. If such a limit is approved by the voters, the city may not broaden the purposes for which the tax may be used unless it holds another election. Any desired change would have to go back to the voters for approval at an election on the issue.

Joint Proposition for a Section 4A Tax and a Sales Tax for Property Tax Relief
A city may include the Section 4A sales tax and the sales tax for property tax relief as separate ballot propositions at the same election. In 1991, the Legislature additionally allowed cities to offer the voters a joint ballot proposition on a sales tax for property tax relief and a Section 4A sales tax for economic development. In this scenario, the voters would vote for or against one ballot proposition that covers the adoption of both taxes.

This joint ballot proposition is popular because it joins the popular incentive of a sales tax to reduce the property tax with the sometimes less popular sales tax for economic development. Under this

joint ballot proposition, the voters are not able to pass the property tax relief sales tax without also passing the Section 4A sales tax for economic development. Either both taxes pass or both taxes fail. The actual wording used on the ballot must indicate what rate is proposed for the Section 4A sales tax and what rate is proposed for the sales tax for property tax relief. If the total local sales tax has reached the legal maximum of 2%, a city may attempt to simultaneously reduce the sales tax for property tax relief and impose the 4A economic development sales tax in one ballot proposition. In this case, the voters would vote for or against the adoption of each of the two taxes and the passage of one would not influence the passage of the other. The city can still use separate ballot propositions, if it does it should be noted that it is not possible to make one ballot proposition dependent on the passage of a separate ballot proposition.

Section 4B Tax

Project and Time Limitations on Section 4B Ballots

There is no required wording for a Section 4B tax ballot. Accordingly, there is no special wording that must be used to limit the use of the Section 4B tax to certain projects. If a city wants to limit the use of Section 4B tax proceeds to certain projects, it may choose to list only the types of projects it desires on the ballot. There is no current authorization for later expanding the purposes for which a Section 4B tax may be expended, other than later authorization by the voters to allow the use of Section 4B money for a sports venue facility. There is no provision under the Act that specifically allows a Section 4B tax to be imposed for a limited time period. By its terms, the Section 4B tax ends once all bonds or other obligations of the corporation that are payable from the Section 4B tax have been paid in full. It should be noted that the law does not state when the development corporation must execute debt in order for the tax to continue, or whether the Section 4B tax may be collected if the corporation either does not execute any debt or has temporarily paid off its obligations.

When Separate Propositions are Required

There is no authorization for a city to offer a joint ballot proposition to approve both a Section 4B sales tax and a sales tax for property tax relief. These two items may be considered at the same election, but they must be voted on individually. A city wishing to adopt both can include a ballot item to approve the Section 4B sales tax and also include a separate ballot item to approve the sales tax for property tax relief.

COUNTY DEVELOPMENT DISTRICT TAX [62]

In addition to the economic development corporations previously discussed, there is an additional mechanism by which counties can pursue economic development at the county level. The County Development District Act authorizes counties with a population of less than 400,000, to generate

[62] This summary is taken solely from a section of the publication "Economic Development through Tourism," 2002 Handbook on Economic Development Laws for Texas Cities, Volume I, Office of the Attorney General, State of Texas (as mentioned previously, this publication is the definitive work on economic development).

sales tax funds for local economic development and tourism-related projects. The statutes governing the creation and administration of county development districts are found in Chapter 383 of the Texas Local Government Code. To date, three counties (Denton, Williamson, and Kaufmann)[63] are either in the process of forming or have formed county development districts check

A county development district can only be created in a county with a population of less than 400,000. A district sales tax can not be imposed if the combined local sales tax rate in any part of the proposed district would exceed the statutory 2% cap. A county cannot initiate a county development district on its own motion. Rather, it must be requested by a petition filed with the county commissioners court of the county in which all of the land in the proposed district is located. The petition must include a sworn statement by all of the landowners indicating consent to the creation of the proposed district.

Once the petition is submitted to the county commissioners court, a public hearing must be scheduled to allow testimony for or against the proposed district. After the required public hearing, the commissioners court must find that the petition meets statutory requirements, and that the district and its proposed projects would be feasible, necessary, and likely to promote tourism or economic development in the county. If the commissioners court finds that the petition does not meet statutory requirements, it must enter an order denying the petition.

A county development district has broad authority to establish projects related to economic development and promotion of tourism in the district. A county development district may acquire or dispose of the same sorts of projects and pay the same sorts of costs as a 4B economic development corporation. However, unlike economic development corporations, which are overseen by the city or county's governing body, Texas law does not require a county development district to get approval from the county before it commits to various projects or expenditures. Among some of the district general powers and duties are the following.

- Expenditure of Tax Proceeds
  If a sales and use tax was approved by the voters in the district and is being collected, the district can use the tax proceeds for the purposes for which the district was created, and to pay bonds issued by the district.

- Hotel Occupancy Tax
  A county commissioners court may impose a hotel occupancy tax of up to 7% within the boundaries of a county development district and can only be imposed outside of the city limits. The hotel tax money may be used by a county development district for any purpose for which the district uses its sales tax proceeds.

- 4B Economic Development Corporation Projects
  The district can pursue 4B projects which could include, among other things, athletic facilities,

[63] These numbers are as of the 2002 date of the aforementioned publication.

tourism and entertainment facilities, certain affordable housing projects, parks and certain public facility and public space improvements, improvements related to commercial businesses, and related transportation and infrastructure improvements.

- Ability to Exercise Powers of Municipal Management District
  The district has and may exercise all powers and rights of a municipal management district under Chapter 375 of the Texas Local Government Code unless such a power or right would be inconsistent with Chapter 383 of the Local Government Code. Additionally, the district has a limited application of competitive bidding laws, a limited eminent domain power, financial transaction powers, the ability to sue or be sued, and the ability to borrow.

Any bonds issued can be used to defray all or part of the costs of the district's projects. To pay the principal and interest on the bonds, the district may use its sales tax revenue, designated project revenues, or any grants, donations or other funds. Bond proceeds can be used by the district to pay interest on the bonds during the acquisition or construction of a project, to pay administrative and operating expenses of a project, to create a reserve to repay the bonds, and to pay all expenses that were incurred during the issuance, sale and delivery of the bonds.

Allocation of the Sales Tax
A county development district may levy a sales tax only if the combined local sales tax rate in any part of the proposed district would not exceed the statutory 2% cap. Other factors also may influence the rate at which a development district can impose a sales tax. For example, if the city in which a district is located imposes or increases its sales tax rate, the county development district's tax rate is automatically reduced to stay below the 2% cap. If a city annexes a district and this results in the combined local sales tax climbing over 2%, the district's tax rate is also reduced to stay under the cap.

Decreasing or Abolishing the Tax
A county development district may decrease or abolish its sales tax in two ways. First, the district's board, on its own motion, may vote to decrease or abolish the tax. Alternatively, the board, at its discretion, may call for an election to increase, decrease, or abolish the tax. The election must be conducted using the same procedures that were followed for the creation of the tax. There is no statutory authorization for a voter-initiated petition to decrease or abolish the tax.

Expansion or Decrease in the Area of the District
The board of directors for the district, or an interested landowner, can ask the county commissioners court to add or exclude land from the district. It is then within the discretion of the county commissioners court whether to approve the proposed expansion or decrease, any approval must be by a unanimous vote of the commissioners court. There is no statutory requirement for a public vote to either increase or decrease the size of the district.

Dissolution of a District
There are three ways in which a county development district can be dissolved. First, if a majority

of the district directors determines that the proposed project cannot be accomplished, the board can ask the commissioners court to dissolve the district. This method is only available if the district has not yet issued any bonds. Second, if a majority of the board finds that all issued bonds and debts have been paid and the purposes of the district have been completed, the board may ask the commissioners court to dissolve the district. These first two methods require a unanimous vote of the commissioners court after notice and a public hearing is provided as required under Section 383.024 of the Local Government Code. If the commissioners court unanimously finds dissolution is in the best interest of the county, all funds and property of the district are transferred to the commissioners court. The third manner in which a district can be dissolved is by agreement with the governing body of a municipality if the district is located wholly within or is wholly annexed by the city. This form requires the district to turn over to the city all money, property, and other assets of the district. In turn, the city is required to assume all contracts, debts, bonds, and other obligations of the district. If such an agreement is made to dissolve the district, the taxes levied by the district end at the same time the district is dissolved.

There is no provision for dissolution of the district pursuant to a petition and/or election of the landowners. However, the district board of directors, as discussed earlier, can order an election to be held on the abolition or reduction of the sales tax that funds district projects. If the voters approve a reduction or abolition of the tax, the district could conceivably continue, but would have to operate with reduced or no sales tax revenue.

MUNICIPAL AND COUNTY HOTEL OCCUPANCY TAX

In Texas, counties and cities can levy a local hotel occupancy tax in order to generate revenue for purposes dedicated to promoting tourism and local hotel and convention activity. Currently, 22 counties and over 500 cities levy the tax. In 2000, this tax generated over $18.2 million for counties, and over $247 million for cities. Funds that these entities can use to fund activities that directly promote tourism and local hotel and convention activity.[64]

Chapters 352, 352, and 156 govern all aspects of the imposition, eligibility, administration, and use of municipal and county local hotel occupancy taxes. Chapter 351 which applies to cities closely mirrors the county counterpart, Chapter 352. However, cities and counties must still each meet different requirements in order to be eligible to adopt a local hotel occupancy tax, at what rate they can impose the tax, and for what purpose they may use the tax revenue. The first part of this section primarily covers the similarities, with some exceptions, between the requirements cities and counties must meet.

Most eligible cities can adopt a tax of up to 7% of the price paid for the use of a hotel room. Counties can levy range from 2% to 7%. Generally there is not a maximum combined rate of state,

[64] Scott Joslove, "What Counties Need to Know to Administer the Local Hotel Occupancy Tax" and "What Cities Need to Know to Administer the Local Hotel Occupancy Tax," Texas Hotel and Motel Association, 2000.

county, and municipal occupancy tax. However, a maximum rate does apply, within the extraterritorial jurisdiction of a city with a population of under 35,000. If a city adopts the tax within its extraterritorial jurisdiction, the combined tax may not exceed 15%. In 2001, Texas had the two highest hotel occupancy tax rates in the country with Houston at 17% and San Antonio at 16 3/4 %. Texas cities have seven of the ten highest hotel occupancy tax rates in the nation.[65]

In order to adopt a hotel occupancy tax, a county must have an existing statutory provision or have passed new state legislation that authorizes it to adopt a county hotel occupancy tax. The county may adopt the tax by order or resolution of the commissioner's court, voter approval is not required to adopt the tax. A city may impose the tax by ordinance.

Chapter 156 of the Tax Code defines which businesses are authorized to charge the local occupancy tax, among the those businesses that fall under the definition of hotels, for both cities and counties, are: hotels, motels, lodging houses, inns, rooming houses, tourist homes, or bed and breakfast. Excluded from the definition are hospitals, sanitariums, nursing homes, and dormitories or other non-hotel housing facilities owned by institutions of higher education.

The tax may be levied against any person, the definition of which includes corporations and other legal entities, who pay for the use of a room in a hotel that is ordinarily used for sleeping. The price of the room does not include the cost of food served by the hotel or the cost of other personal services.

There are several statutory exemptions from assessment of the local occupancy tax. Among the various exemptions are persons who have contracted to use a hotel room for more than 30 consecutive days, certain federal and other high level officials traveling on federal business, and officers or employees of a state agency, institution, board, or commission who are traveling on official business. City and county officers and employees however, are not exempt from the state or local hotel occupancy tax, even if traveling on official business. Additionally, neither cities nor counties are authorized to grant any additional exemptions to the tax without new constitutional or statutory authority.

The hotel occupancy tax is paid by the hotel customer to the hotel, who then remits it to the county or city on a regular basis. The Comptroller's Office is not involved with the tax collection process. There is statutory authority for cities and counties to allow hotel operators to retain up to 1% of the amount of hotel occupancy taxes collected as reimbursement for the costs of collecting the tax. There is however, no authority for a city or county to retain any of the tax collected to cover their costs of imposing or collecting the tax.

State law provides for specific penalties that may be assessed against hotel operators who fail to report or pay taxes when due or who file fraudulently. Counties can impose penalties based on a variable percentages on the tax due, which is dependent on how late the taxes are. A city can impose

[65] Ibid.

a similar percentage based penalty, but state law allows cities the ability to criminally prosecute the hotel operators and to levy heftier fines. There is additional civil actions that cities and counties are authorized to pursue against a negligible hotel operator as well.

Use of Revenue

There is a two part test that every city's, and some counties', expenditure of local hotel occupancy tax must meet in order to be valid. There are some additional rules that certain other counties and cities must comply with in determining how they can use their occupancy tax, these will be discussed later. One similarity however, is that there is no time limit for either a city or county to expend all of its hotel occupancy tax revenues.

The first part of the test is that every expenditure must directly enhance and promote tourism and the convention and hotel industry. In order to comply, the event or facility that is being funded must both directly promote tourism and directly promote the convention and hotel industry. In order to promote tourism the activity must bring visitors from outside the area into the city/county. In order to promote the convention and hotel industry, the event or facility must be likely to cause increased hotel or convention activity. This last component is not specifically defined by law, but it is a practice that has been interpreted as such by the Attorney General's Office and by the Texas Municipal League. If the funded event or facility is not likely to have the required effect, city or county hotel occupancy tax revenues cannot fund it. Additionally, local hotel occupancy tax revenues may not be used for purposes that a city/county usually expends general revenues on. Nor can the tax be used to pay for any governmental expenses not directly related to increasing tourism and hotel and convention activity. Even if the expenditure would indirectly promote or enhance tourism and hotel and convention activity, the law forbids the expenditure unless it is direct related.

The second part of the test requires that every expenditure clearly fit into one of six statutorily provided categories, which are as follows:[66]

- Establishment, improvement or maintenance of a convention center or visitor information center. The law requires that any new facility must be one that is primarily used to host conventions and meetings that directly promote tourism and the hotel and convention industry. Primarily meaning at least 51% of the bookings. Convention center is defined by statute to include civic centers, auditoriums, exhibition halls, and coliseums that are owned by a city, county, or other governmental entity that is managed in whole or in part by the city/county.

- Administrative costs for facilitating convention registration. This provision allows expenditures for the administrative costs that are incurred for assisting in the registration of convention delegates or attendees. It may include covering the personnel costs and costs of material for the registration of convention delegates or attendees.

[66] Ibid.

- Advertising, solicitation, and promotion costs that attract tourists and convention delegates. These costs are authorized if directly related to attracting tourists and convention delegates to the city/county or its vicinity. Traditionally these include newspaper, mail, television, or radio ads or solicitations to promote an event or facility.

- Expenditures that promote the arts. Specifically, the statute allows for funding that encourages, promotes, improves, and applies the arts, in its various statutorily defined forms, so long as it is related to the presentation, performance, execution, and exhibition of these major art forms. Again, these expenditures are only authorized if these art-related programs promote tourism and local hotel and convention facility.

- Funding Historical Restoration or Preservation Programs. These expenditures are for the enhancement of historical restoration and preservation projects, within a city/county or vicinity that are likely to attract tourists and hotel guests.

Cities located in a county with a population of 65,000 or less.[67]

- Costs related to sporting events that substantially increase hotel activity. To qualify the sporting event must be one that would substantially increase economic activity at hotels and motels within the city or its vicinity. The majority of the participants must also be tourists to the area. This category was intended for smaller communities that lack a convention center and applies to cities located in 206 of the 254 counties that levy a hotel occupancy tax.

As mentioned previously, there are additional rules that apply to the expenditure of the hotel occupancy tax for certain cities and counties. There are seven categories of counties that have special rules regarding their use of the county tax.[68]

- County with a population of more than 3.3 million.
  Only Harris County falls under this category. The maximum rate applicable depends on whether the hotel is within the city limits, where the rate is 2% or outside of Houston, were the rate is 7%. There are only three purposes allowed for the expenditure of the tax: 1) public improvements, such as civic centers, exhibition halls, coliseums and stadiums, that serve the purpose of attracting visitors; and expenditures for parking areas or municipal hotels; 2) registration of convention delegates or registrants; and 3) general promotion and advertising of the county to promote tourism.

- County bordering Mexico and having a population of 90,000 or more and not having three or more cities that each have a population of more than 17,500.
  This category applies only to El Paso and Webb county. The maximum rate in these two

[67] Ibid.

[68] Ibid.

counties is 7%; Webb county may impose the tax within all of its municipalities, whereas El Paso county can only do so in areas in which the city hotel occupancy tax is not in effect. The limited expenditures are: 1) funding the establishment, improvement or maintenance of a convention center or visitor information center, 2) paying the administrative costs for facilitating convention registration, 3) promotion and tourist advertising of the county and its vicinity and convention solicitation, 4) encouragement, promotion, improvement or application of historic preservation and restoration, and 5) encouragement, promotion, improvement and application of the arts.

- County with no municipality.
  Only ten counties (Borden, Crockett, Glasscock, Jim Hogg, Kenedy, King, Loving, McMullen, Terrell, and Zapata) have no municipality and fall under this category. The expenditure of the tax is limited to: 1) funding the establishment, improvement or maintenance of a convention center or visitor information center, 2) administrative costs for facilitating convention registration, 3) encouragement, promotion, improvement and application of the arts, 4) general promotional and tourist advertising of the county and convention solicitation, or 5) historic preservation and restoration.

- County having a population of 17,5000 or less, no more than one municipality with a population of less than 2,500, and bordering Edwards Aquifer Authority.
  Only Bandera County falls under this category with a maximum rate of 7%, which can be applied to all of the municipalities within the county. The sole expenditure for the tax is for the general promotional and tourist advertising of the county and its vicinity and for convention solicitation.

- County bordering the Gulf of Mexico.
  This category applies to 16 counties (Aransas, Brazoria, Calhoun, Cameron, Chambers, Galveston, Jackson, Jefferson, Kenedy, Kleberg, Matagorda, Nueces, Refugio, San Patricio, Victoria, and Willacy), with a maximum tax rate of 7%. Kenedy County is capped at 4% because it also falls under the previous category of a county without any municipality. Additional there is statutory language restricting Chambers County to 3% and Jefferson County to 2%. The counties in this category, except for Chambers and Jefferson, are not permitted to impose the tax in cities that already have a city hotel tax. The tax expenditure limitations are for 1) clean public beaches, 2) acquire, furnish, or maintain facilities to enhance public access to beaches, 3) provide and maintain public restrooms, 4) provide and maintain litter containers on or near beaches, 5) create, renovate, promote and maintain parks adjacent to waterways, or 6) advertise and conduct solicitations and promotional programs to attract tourist and convention delegates.

- County bordering Mexico and having a population between 300,000 and 600,000.
  Only Cameron and Hidalgo County fall under this category with a maximum rate of 7%, rate which does not apply where the city hotel tax is applied. These two counties are limited to only spending the tax for the purpose of bond debt service, construction, maintenance, or operation

of a special events facility with a seating capacity of at least 8,000.

- County that borders Mexico and contains a National Park.
  Only Val Verde County with a 7% maximum tax rate falls under this category. The hotel tax can be applied regardless of a city hotel tax, and is limited to expending 75% of its revenue for the promotion of tourism and 25% for general revenue purposes or general governmental operations of the county.

There is also a special treatment of counties with a population of less than 600,000 within county development districts. These counties (except for Bexar, Dallas, El Paso, Harris, Tarrant, and Travis), are authorized through the commissioners court to impose a hotel tax, however, this tax must be remitted to the county development district and may only be used to attract visitors and tourists to the county. As discussed in the county development district section of this report, the tax can only be imposed after it is approved at an election. The tax in within these district can not exceed 7% nor can it be imposed within city corporate limits.

Cities also face additional limitations which is dependent on their population. Unlike the county additional rules, these primarily govern the percentage of hotel occupancy tax revenues that may be expended on the six categories previously discussed.[69]

- Cities with a population of over 200,000.
  The nine cities that fall under this category are Arlington, Austin, Corpus Christi, Dallas, El Paso, Fort Worth, Garland, Plano, and San Antonio. These cities have a required 50% minimum expenditure that must be spent on advertising and promotion. Additionally, these cities can spend no more than 15% each, on the arts and historical restoration and preservation.

- Special rules for Houston.
  A minimum of 23% on advertising and promotion, unless the expenditure impairs the ability to spend the revenue for operation and maintenance of its convention center or to pledge revenue for the payment of convention center bonds. A maximum of 19.30% or the amount of tax received by the city at a rate of 1% of the cost of the room, whichever is greater, may be spent on promotion of the arts. The city can also pledge tax revenue for a convention center hotel or historic hotel, but only the revenue collected at that particular hotel.

- Certain large coastal communities, including Corpus Christi.
  All or any portion of the tax may be used toward cleaning and maintaining public beaches from the taxes collected at hotels that are within areas newly annexed by Corpus Christi. The city can use revenue from the portion of hotel tax that exceeds 7%, up to a maximum of 9%, for acquiring land for a municipally owned convention center, constructing, improving operating and maintaining the convention center; and paying bonds to finance these activities.

[69] Ibid.

- Eligible central municipalities.
  Dallas, Fort Wort, and San Antonio fall into a category of cities with a population of more than 440,000 but less than 1.5 million that is located in a county with a population of one million or more and that has adopted a capital improvement plan for the expansion of an existing facility. This category of cities can pledge tax revenue for a municipal convention center, but only the revenue collected at the particular hotel. Dallas falls into an additional category that has additional limited uses for tax revenue derived over a 4% rate. Fort Worth and San Antonio also fall into another category that requires them to use the revenue derived over a 7% rate for construction of an expansion of an existing convention center.

- Cities with a population between 125,000 and 200,000.
  The seven cities that fall under this category are Amarillo, Brownsville, Grand Prairie, Irving, Laredo, Lubbock, and Pasadena. These cities must spend a certain amount on advertising and promotion, the amount dependent on the rate of the hotel tax. If the rate is no more than 3%, then ½ of 1% must be spent, if it exceeds 3%, then at least 1% must be spent. Additionally, these cities can spend no more than the greater of either 15% of the hotel tax, or the amount of tax received at the rate of 1% of the cost of the room, on historical restoration and preservation.

- Cities with a population of less than 125,000.
  Cities that fall under this category must spend a minimum of ½ of 1% of the hotel tax, if the rate is 3%, on advertising and promotion. If the rate exceeds 3%, then 1% of the rate must be spent on advertising and promotion. These cities must not spend more than 15% of the tax, or no more than the amount of tax received at the rate of 1% of the cost of a room, whichever is greater, on the promotion of the arts. If the city does not allocate hotel tax for a convention center, than the city is prohibited from allocating more than 50% of the hotel tax for historical restoration or preservation projects.

- Eligible coastal municipalities.
  The sixteen cities that comprise this category are Aransas Pass, Baytown, Freeport, Galveston, Ingleside, La Marque, La Porte, Palacios, Port Aransas, Port Arthur, Port Isabel, Port Lavaca, Portland, Rockport, Sea Brook, and Texas City. These cities are defined as home-rule municipalities that border the Gulf of Mexico and have a population of less than 80,000. The revenue of these cities are limited in four ways: 1) minimum expenditure for improvements to civic centers, hotels, marinas, golf courses, trolleys, and other improvements that attract tourists; 2) minimum expenditure for matching funds for beach clean-up; 3) minimum 1% expenditure for other beach related expenditures, and 4) minimum 3% expenditure for advertising and promotion.

Management of Funded Activities

The governing body of a city/county is authorized to delegate the oversight of programs that are funded by the hotel occupancy tax. They can do so by written contract and may be done with a person, another governmental entity, or a private organization. Most often this type of delegation is made to local arts council, a chamber of commerce, or to the convention and visitor bureau. The

entity that is the recipient of this delegation undertakes a fiduciary duty towards the governing body with regard to the use of the hotel tax revenue. Under state law, the hotel tax can be used to cover a portion of administrative costs that the managing entities incur, so long as those costs are attributable to implementing tourism-related activities that may be funded by the hotel tax. These expenses can include day-to-day operational expenses, but can only be reimbursed if incurred in the promotion and servicing of expenditures authorized on the hotel occupancy tax laws. The portion of the costs cannot exceed the cost that is attributable to the activity funded by the hotel tax.

MASS TRANSIT

Mass transit is governed by Chapters 451, 452, and 452 of the Transportation Code. Each of these chapters pertains to each of the three categories of transit authorities: metropolitan area authority, municipal authority, and regional authority. However, the imposition, assessment, collection, administration, and enforcement of the sales and use tax is governed by Chapter 322 of the Tax Code.

Transit authorities were created by citizens in major population areas to finance and improve mass transportation systems. Texas has eight different existing transit authorities that are financed by a transit sales tax, which is collected by businesses at a rate of up to 1%.[70] (See Appendix)

METROPOLITAN RAPID TRANSIT AUTHORITY

Chapter 451 of the Transportation Code governs a metropolitan transit authority's ability to impose and generate revenue from a sales and use tax. In order to impose a tax or increase the rate of an existing tax, a proposition proposing the imposition or increase must be approved by a majority of the voters at an election held for that purpose. Each new tax or rate increase must be expressed in a separate proposition consisting of a brief statement of the nature of the proposed tax.

The board that governs the authority shall, before an election to authorize a tax, adopt complete tax code and rules providing for the nature of the tax, the tax rate, and the administration and enforcement of tax. The board can, after an election approving the tax, amend the tax code and rules.

The sales and use tax rate may be imposed as 1/4, ½, or 3/4 of 1%, or 1%. However, the rate, including a rate increase, may not when combined with the rates of all sales and use taxes imposed by other political subdivisions exceed 2% in any location in the transit authority. A decrease in the tax rate may be ordered by the board or through an election to decrease the tax. Whereas an increase to the tax rate, may only be accomplished through an election, as ordered by the board or through a petition submitted by the registered voters of an authority. The petition must be submitted by at least 10% of the authority's registered voters. However, if the board has reduced the tax rate without an election, then the board, by order, may increase the rate to a rate not in excess of the rate before the ordered decrease.

[70] "Transit Authority Sales Tax," Texas Comptroller of Public Accounts, August 2002.

Revenue Use
The metropolitan authority may use the sales tax revenue to acquire, construct, develop, own, operate, and maintain a transit authority system in the territory of the authority, including the territory of a political subdivision. An authority may also contract with a municipality, county, or other political subdivision for the authority to provide public transportation services outside the authority and lease all or part of the transit authority system to, or contract for the operation of all or a part of the transit authority system by an operator. An authority may not lease the entire transit authority system as mentioned above without the written approval of the governing body of the principal municipality of the authority. An authority created by an alternate municipality and an authority in which the principal municipality has a population of more than 1.2 million may contract for service outside each of their respective territories to provide access between the two authorities.

Parking Areas
An authority created before 1980 in which the principal municipality has a population of less than 1.2 million may, with the approval of the governing body of the principal municipality establish, operate, and improve a public parking area or facility in the authority and set and collect reasonable charges for the use of a parking area or facility. This authority may regulate public parking in public parking areas or facilities in the principal municipality under an interlocal agreement with the principal municipality according to which the power is delegated to the authority.

Roadways, Trails, Lighting
An authority that is confirmed before July 1, 1985, may, in the authority, construct or maintain a highway, local or arterial street, thoroughfare, or other road, including a bridge or grade separation and install or operate traffic control improvements, including signals. This type of authority may also construct or maintain a sidewalk, hiking trail, or biking trail, install or maintain streetlights. In performing an activity under the aforementioned tasks, the authority may make drainage improvements and take drainage-related measures as reasonable and necessary for the effective use of the transportation facility being constructed or maintained. These activities may be performed through an agreement with another governmental entity, including an agreement under Chapter 791 of the Government Code, and with a state agency listed under Section 771.002 of the Government Code. The above mentioned activities are only authorized when a municipality receives consent from the governing body of the municipality or a contract with the municipality specifying the actions that the authority may undertake.

Spending Limitation
There are certain spending limitations applicable to an authority confirmed before 1980 in which the principal municipality has a population of more than 1.2 million. This type of authority is prohibited from spending, during any five-year period, more than 7% of its revenue from sales and use taxes and interest income during that period for, as mentioned in the aforementioned section, construction or maintenance of a sidewalk, hiking trail, or biking trail or for the installation or maintenance of streetlights. For a fiscal year in which an authority described above in this section, spends an amount that exceeds the limit set out above, the registered voters of the authority, by petition, may require than an election be held on the question of eliminating or reducing

expenditures in any category authorized by Section 451.065(b) and not otherwise authorized by Section 451.065(a). The board shall call an election to be held at least 60 days after the date the election order is issued if the secretary of state finds that a petition for the election is valid or fails to act within the time required by this section.

Emergency Medical Services
An authority in which the principal municipality has a population of less than 300,000 may provide emergency medical services.

Free Fares Program
An authority confirmed before July 1, 1985, and in which the principal municipality has a population of less than 750,000 may, through the operation of a program, charge no fares. A program under this section must have clearly defined goals adopted by the authority, expires annually, unless renewed, and may be renewed only after the program's costs and benefits are evaluated.

Regional Economic Development Facilities in Stations or Terminal Complexes
Regional Economic Development Facilities, includes only those facilities that will lead to the creation of new jobs, maintain existing jobs, or generally improve the conditions under which a local economy may prosper. The term includes facilities primarily used for conventions, entertainment, special events, or professional or amateur sports.

Station or Terminal Complex: Additional Tax
An authority may collect an additional tax to provide for the planning, acquisition, establishment, development, and construction of a station or terminal complex that includes regional economic development facilities as defined in section 451.201.

Use of Revenue for Regional Economic Development Facilities
Revenue from the additional tax may only be used to finance a project described in the ballot proposition for the tax. The dedication of this revenue has a five year duration, and money not used for the regional economic development facilities portion of a station or terminal complex may be used or other purposes.

Continuation of Tax Rate Increase
On the expiration of the dedication of the sales and use tax rate increase revenue, the board shall decrease the tax rate to its previous rate unless the board determines that the revenue from the increase rate is necessary for purposes other than the regional economic development facilities portion of the station or terminal complex. The board is required to submit the question of the continuation of the increased rate to the voters.

REGIONAL TRANSPORTATION AUTHORITIES

Chapter 452 authorizes regional transit authorities the ability to generate revenue through the sales and use tax. An authority may impose a sales and use tax at the rate of 1/4%, ½%, 3/4%, or 1%.

The imposition must be approved at an election and may not be imposed in a unit of election that has not confirmed the authority. The rate in an authority created by a contiguous municipality must be approved by the governing body of the contiguous municipality.

Any increase must be approved by the voters at a confirmation election with a majority vote in favor of the increase at an authority-wide election. An authority may not adopt a sales and use tax rate, including a rate increase, that when combined with the rates of all sales and use taxes imposed by other political subdivisions having territory in the authority exceeds 2% in any location in the authority.

The executive committee of the transit authority by order may direct the Comptroller to collect the authority's sales and use tax at a rate that is lower than the rate approved by the voters at a confirmation election. In the case of sub-regional tax rates, an executive committee may by order direct the Comptroller to collect the authority's tax at different rates in different subregions of the authority. A rate however, may not be higher than the maximum rate approved by the voters.

Revenue Use of Tax
This section allows this type of transit authority to acquire construct, develop, plan, own, operate, and maintain a public transportation system in the territory of the authority, including the territory of a political subdivision. The authority can also contract with a municipality, county, or other political subdivision for the authority to provide public transportation services outside the authority and lease all or part of the public transportation system to, or contract for the operation of all or part of the public transportation system by, an operator.

MUNICIPAL TRANSIT AUTHORITIES

Chapter 453 of the Transportation Code governs a municipal transit department's ability to impose sales and use taxes. A board may impose, for the transit department, a tax at a permissible rate that does not exceed the rate approved by the voters. The board by order may decrease the rate of the tax for the transit department to a permissible rate or call an election for the increase or decrease of the tax to a permissible rate. Permissible rates are 1/4 of 1% or ½ of 1%. A board however may not adopt a rate, including a rate increase, that when combined with the rates of all sales and use taxes imposed by all political subdivisions having territory in the municipality exceeds 2% in any location in the municipality. In order to change the tax rate, approval is required by the voters.

A transit department in the municipality creating it, may use the tax revenue to acquire, construct, own, operate, and maintain a transit system. The transit department may also use any public way and construct, repair, and maintain a municipal street, as authorized by the governing body of the municipality. Additionally, in achieving the aforementioned, a transit department may relocate or reroute, or alter the construction of any public or private property. Among the property eligible for relocation or rerouting are an alley, road, street, or railroad; and electric line and facility; a telegraph and telephone property and facility; a pipeline and facility; and a conduit and facility.

SPORTS AND COMMUNITY VENUE TAX

During the 1997 legislative session, the 75th Legislature passed House Bill 92, known as the sports and community venue project. The bill provides broad authority to cities and counties to levy certain taxes and issue bonds to finance a wide array of economic development projects, in addition to the construction of sports and community venue projects. Cities and counties are authorized to propose the adoption of a number of new revenue sources to finance any economic development project authorized by law. Cities and counties may also choose to propose a venue project tax if they are interested in diversifying the sources of revenue they have to promote a specific economic development project. Additionally, the venue project revenue sources that can be adopted include a hotel occupancy tax, a short-term motor vehicle rental tax, an event parking tax, an event admissions tax, and a venue facility use tax.[71]

The sales tax, it can be proposed in certain limited cases even if the city is already at its maximum sales tax rate. In this circumstance, the legislation allows the voters to approve an automatic reduction of another existing sales tax to make room for the venue tax. However, before a local government may use any of the taxes authorized, both the tax and the venue project on which it will be spent must be approved by the voters. The proceeds from such a tax may be spent only on the approved venue project.[72]

This legislation added Chapters 334 and 335 to the Local Government Code and section 321.508 to the Tax Code. Section 321.508 authorizes a city at an election to propose up to 25% of its sales tax revenue to finance all or part of the costs of one or more venue projects. The legislation also amended the Development Corporation Act of 1979 to allow either a section 4A or section 4B development corporation to submit a proposition to voters to authorize the use of section 4A or section 4B sales tax revenue for specific projects, including sports and community venue projects. Another feature of the legislation gave voters the option to approve or reject a reduction of an existing local sales tax to make room for a venue tax.[73]

Chapter 334 of the Local Government Code allows a city or county to undertake a venue project, with either the city or county commissioners court as the governing body over all venue projects. Chapter 335, however, is more expansive in that it permits a city, a county or both to work jointly with any number of other cities and counties. Under Chapter 335, a "venue district" is formed and a board of directors is appointed to serve as the governing body over all venue projects. Additionally, these latter types of districts may carry out the same types of projects and propose the

[71] "Sports and Community Venues, A New Way to Do Things and Pay for Them", Texas Comptroller of Public Accounts and "2002 Handbook on Economic Development Laws for Texas Cities", Volume 1, Office of the Attorney General, State of Texas.

[72] Ibid.

[73] Ibid.

same financing methods as an individual city or county could under Chapter 334.[74]

Both chapters, of the Local Government Code have provisions requiring voters to approve or reject the construction, improvement, infrastructure, and method of financing venue projects. Although Chapters 334 and 335 have many points in common, the focus here is primarily on Chapter 334 of the Local Government Code.[75]

Venue Project

Chapter 334 applies to all cities and counties in Texas, regardless of population and geography. Certain special conditions however, are set forth for the City of Houston and Harris County. Cities and counties are allowed to undertake a "venue project", which is statutorily defined as a "venue and related infrastructure that is planned, acquired, established, developed, constructed, or renovated under this chapter." The term is used rather loosely to include just about anything, including:

- Arena, coliseum, stadium, or other type of area or facility: a) that is used or will be used for professional or amateur sports, or for community and civic and charitable events; and; b) where a fee for admission to these events will be charged; or

- Convention center or a related improvement that is located in the vicinity of the convention center. The term "related improvement" is used broadly and includes such things as civic center hotels, auditoriums, theaters, opera or music halls, exhibition halls, rehearsal halls, parks, zoos, museums, or plazas; or

- Tourist development area along an inland water way; or

- A municipal parks and recreation system, improvements or additions to a parks and recreation system, or an area or facility that is part of a municipal parks and recreation system; or

- Any other economic development project authorized by law. (This category appears to allow the use of the authority for any project that would be authorized under any other Texas economic development statute.) from an arena, an aquarium, a coliseum, a stadium, a museum, to a facility to accommodate either or both professional and amateur sports events.[76]

The term "related improvements or infrastructure" is also used freely to include any on-site or off-site improvements, among them hotels, auditoriums, exhibition halls, theaters, restaurants, music halls, parking, water, sewer, streets, roads, plazas, and other improvements which enhance the use, value or appeal of a venue. A city or county may only use Chapter 334 to construct a project that

[74] Ibid.

[75] Ibid.

[76] Ibid.

falls within the definition of the term "venue" or within the definition of "related infrastructure." However, once construction is completed, state law permits the facility to be used for an even that is not related to one of the above-described venue purposes, such as community related events. Also, if an already existing facility would qualify as a venue project under Chapter 334, a city or a county may use the authority granted under Chapter 334 to aid that facility even though it was originally constructed or undertaken under the authority of other law. Therefore, it appears that cities can and are using Chapter 334 in a variety of ways that are not necessarily apparent from the language in the statute.[77]

Authorizing a Venue Project

Before calling an election, a city or a county must send to the Comptroller of Public Accounts a resolution proposing each venue project and method of finance. The Comptroller will determine the fiscal impact on the state's revenue, and make the results of its analysis available in writing. If the analysis shows a significant negative impact on the state's revenue, the Comptroller must then provide recommendations on how to avoid this significant negative impact. If the Comptroller does not provide an analysis within 29 days, the resolution is considered approved by the Comptroller. A city or a county has 10 days to contest and appeal a ruling made by the Comptroller, and in response the Comptroller must perform a second analysis. If the second analysis shows a negative impact on state revenue, the Comptroller must once again provide recommendations on how to avoid a negative impact on state revenue. However, if the Comptroller does not provide a second analysis before the 30th day after an appeal is made, the resolution is considered approved.[78]

Transportation Authority Impact Analysis

Before calling an election, a copy of the resolution must also be submitted to the transit authority if the resolution for the project contains a proposed sales and use tax that would result in a tax rate reduction of the transit authority. The transit authority has 30 days from the date of receiving the resolution to perform an analysis to determine whether the proposed tax would cause a negative impact on its ability to provide service and meet existing contracts. If the transit authority does not provide the analysis within a 30-day period, the resolution is considered approved by the authority. If a transit authority determines that a resolution would have a significant negative impact on its ability to provide service and meet its existing contracts, a city or a county can appeal such a determination to the Comptroller.[79]

Election

A city or county must receive voter approval of the project and the proposed means of financing the project. The order calling the election must allow the voters to: 1) vote separately on each venue project; 2) designate the venue project; 3) designate each method of financing authorized by Chapter

[77] Ibid.

[78] Ibid.

[79] Ibid.

334 that the city or county wants to use to finance the venue project and designate the maximum rate for each method; and 4) allow the voters to vote (in the same proposition or in separate propositions) on each method of financing authorized by Chapter 334 that the municipality or county wants to use to finance the project and the maximum rate of each method.[80]

If the venue project is for improvements or additions to an existing park or recreation facility, the description of the project in the ballot proposition must identify each park or recreation facility by name or location. If the venue project is for the acquisition or improvement of a new park or recreation facility, then the description of the project in the ballot must specify the general location where the new park, recreational system, or facility will be located. If the venue project includes improvements and/or additions to all parks and/or recreation facilities of the city, then the ballot proposition description need not contain the name or location of the facilities[81].

Revenue Options
At an election, a city or a county may present to voters a tax package from the options listed below. However, each tax must be voted on separately with specific ballot language. Each tax must be abolished when the bonds or other obligations are paid off.[82]

- Sales and Use Tax
  A local sales and use tax can be adopted at 1/8, 1/4, 3/8, or ½ of 1%. A sales tax adopted under Chapter 334 may be increased if approved at an election. The rate can be at the same increments as the adoption rates, however, the increase must not cause the local sales and use tax to exceed 2%. However, a city or county is not automatically forbidden from adopting or increasing a sales tax to pursue a venue project merely because adoption would cause the combined local sales tax in an area to exceed the 2% cap. Instead, as mentioned above, state law allows the adoption of the venue sales tax, under Chapter 334, to cause the local sales tax rate of one of the other taxing authorities in the area to be automatically reduced.

- Short-term Motor Vehicle Rental Tax
  This tax can be adopted in increments of 1/8 of 1% up to 5% on rentals of 30 days or less. The tax is on the gross receipts from the motor vehicle rental. Once in place, the rental tax may be decreased or abolished, by ordinance or order, on the city or county's own motion. However, the tax may only be increased if the increase is approved at an election and the resulting tax rate will not exceed 5%. Also, a rental tax may not be imposed to fund a venue project that is an area or facility that is part of a municipal parks and recreation system. All revenue must be deposited in the venue project fund.

[80] Ibid.

[81] Ibid.

[82] Ibid.

- Event Admissions Tax
  Tax may be imposed on each admission ticket sold for an event at the venue project. The rate may be set at any uniform percentage, but the maximum tax rate on the price of a ticket is 10% of the price of the admission. Once in place, the tax may be decreased or abolished on the city or county's own action. The tax can be increased only if the increase is approved at an election and the rate will not exceed 10%. All revenue from the tax must be deposited in the venue project fund.

- Event Parking Tax
  The tax imposed on each motor vehicle that parks in a parking facility of a venue project. This tax may be a flat tax per parked vehicle or a percentage of the parking fee, but no more than $3 per vehicle. The rate may be decreased or abolished, by ordinance or order, on the city or county's own motion. Increase may occur only if approved at an election and the resulting rate will not exceed $3. All revenue from this tax must be deposited in the venue project fund.

- Hotel Occupancy Tax
  In order to fund a venue project within its boundaries, a city or county may impose a tax at any percentage but not to exceed the rate of 2% on the use of a hotel room. This additional tax may not be imposed to fund a venue project that is an area or facility that is part of a municipal parks and recreation system. If approved by voters, the tax is in addition to any local hotel occupancy tax that the city or county may impose under Chapter 351 or 352 of the Tax Code. There does not appear to be a prohibition the adoption of this additional tax even if the city or county is already at its statutory maximum for the local hotel occupancy tax under Chapter 351 or Chapter 352 of the Tax Code. Other than requiring the tax to be discontinued when all the venue project obligations are paid off, Chapter 334 does not appear to provide any clear authority for a city or county to decrease or abolish the additional tax. All revenue from this tax must be deposited in the venue project fund.

- Venue Facility Use Tax
  This tax may be levied on each member of a major league team that plays in a venue facility. The tax rate may be set at any uniform amount, but the maximum tax is $5,000 per player per game. The tax may be decreased or abolished, by ordinance or order, on the city or county's own motion. All revenue from the tax must be deposited in the venue project fund.[83]

LIBRARY DISTRICT SALES TAX

During the 75th legislative session, the Legislature added Chapter 326 to the Local Government Code in order to enable rural and suburban areas to create library districts and to adopt a local sales tax.

A county is eligible to create a library district so long as the district includes any contiguous territory

[83] Ibid.

within a single county. The county must hold an election to confirm the creation of a district. In order to hold an election on the issue, the commissioner's court must receive a petition signed by at least 5% of the voters in the proposed district. Among the other requirements, the petition must contain the proposed sales tax rate upon approval of the district. The commissioners court must give notice of the election by publishing a substantial copy of the election order no earlier than the 30th day or later than the 10th day before election day.[84]

A district may levy a sales tax to fund in the district if authorized by a majority of the qualified voters in the creation, and if the total combined rate of all local sales and use taxes would not exceed 2% at any location within the district. The permissible rates for the district sales tax are 1/8, 1/4, 3/8, or ½ of 1 %.

The use of the tax revenues is limited to fund the purpose of the district, being to establish, equip, and maintain one or more public libraries for the dissemination of general information relating to the arts, sciences, and literature. The district is also authorized to invest its tax revenue in authorized investment. Additionally, during the 77th legislative session, the Local Government Code was amended to allow library districts to purchase, acquire, own, maintain, or improve land. This legislation also authorizes the pledging of sales and use taxes as collateral for borrowing money to further a library district's purposes.[85]

After the creation of a district, a board by order may decrease or abolish the sales tax rate. A board may also call an election to increase, decrease, or abolish the sales tax rate. Additionally, a district may only be expanded if the county commissioners court calls and holds an election for that purpose in the territory to be added to the district.

The district is governed by an elected board of trustees. The board controls and manages the affairs of the district. The board may hire any person, firm, partnership, or corporation the board considers necessary for conducting the district's affairs. A district has all of the powers, authority, rights, and duties necessary for the accomplishment of its purposes. Among these powers are the right to borrow money, purchase, construct, acquire, own, operate, maintain, repair, or improve any works, materials, supplies, improvements, facilities, equipment, vehicles, machinery, or appliances necessary for the district. The board also may adopt bylaws to govern the district.[86]

MUNICIPAL TAX FOR STREET MAINTENANCE

Prior to the 77th Legislature, certain municipalities were prohibited from adopting an additional sales and use tax. In response, the 77th Legislature passed House Bill 445 that authorizes a

[84] "Library District Sales Tax", Texas Comptroller of Public Accounts, October 2001.

[85] Ibid.

[86] Ibid.

municipality to adopt a sales and use tax for the maintenance and repair of municipal streets.

Under Chapter 327, a municipality may adopt a sales and use tax at an election held in the municipality for that purpose. The rate of the tax authorized by the chapter is 1/4 of 1%. A municipality may not adopt the tax if, as a result of its adoption, the combined rate of all sales and use taxes imposed by the municipality and other political subdivision having territory in the municipality would exceed 2% at any location in the municipality.

Revenue from the tax may be used only to maintain and repair municipal streets existing on the date of the election to adopt the tax. A municipal street is defined as the entire width of a way held by a municipality in fee or by easement or dedication that is open for public use for vehicular travel. Excluded from this definition are designated state or federal highway or road or a designated county road. This tax requires re-authorization at an election called to re-authorized the tax or the tax will expire after a specified term.

Local Government Impact of municipalities surveyed indicated that street repair and maintenance costs range from $12-$16 million. Municipalities with an average population of 300,000, estimate that they could collect an additional $4.5 million annual in revenue based upon the provisions of the legislation. Small municipalities, with a population of less than 50,000, estimate an annual revenue gain of $1 million.[87] The municipalities would continue to experience this revenue gain to help pay expenses for street repair and maintenance for the four-year period in which the sales and use tax would be in effect.

BETTER JOBS ACT

During this past 77th Legislature, Senate Bill 607, the "Better Jobs Act" was passed. The purpose of this legislation was to create programs that are in the public interest, promote the economic welfare of the state, and serve the state public purpose of developing and diversifying the economy of Texas. Through SB 607, municipalities throughout Texas are able to have a substantial interest in developing resources to foster a highly-skilled workforce in order to reduce unemployment and under employment. This legislation provides another mechanism for city revenue to fund economic development programs. Municipalities through a municipal development corporation can now provide additional educational and job training opportunities to its citizens. Municipalities are also able to develop additional resources to invest funds in economic development programs such as: job training, early childhood development, after-school programs, higher education scholarships, and literacy programs.

SB 607 amended Title 12A of the Local Government Code by adding Chapter 379A, entitled

[87] These figures where derived from the fiscal note prepared by the Legislative Budget Board during the 77th legislative session.

"Municipal Development Corporation." Much like establishing an Economic Development Corporation, a city is required to hold an election in order to impose a sales tax to fund the corporation and file an incorporation fee. The board of directors of the corporation would be required to submit an annual report to the Comptroller of Public Accounts detailing the corporation's total revenue, expenditures, and capital assets. The Comptroller would be authorized to impose an administrative penalty if the report is delinquent and is required to submit a report on the use of this local sales tax to the legislature each biennium.

As noted above, like other dedicated local sales and uses taxes, a municipality must hold an election to establish the tax. The adoption of the tax may be limited on the ballot to any specific program, or the tax may be adopted with general language permitting the use of the tax for any purpose authorized by this chapter. If a tax is levied, it may be adopted for a maximum of 20 years, but may then be reauthorized, subject to a payment of indebtedness. The tax may also be authorized for a shorter period of time or limited to the time necessary to pay any indebtedness.

The rate adopted under this section must be 1/8, 1/4, 3/4, or ½ of 1%. A municipality may not adopt a tax rate under this chapter if the adoption would result in a combined tax rate of all local sales and use taxes of more than 2% in any location in the municipality.

The municipality's imposition, computation, administration, collection, and remittance of a tax authorized by Chapter 321 of the Tax code, except as inconsistent with the authorizing local government code. Any change in the rate however, is governed by Section 379A. A municipality that has adopted a tax rate under this chapter at the rate of ½ of 1% may increase or decrease the rate of the tax if the increase or decrease is approved by a majority of the voters voting at an election held for that purpose. The tax may be increased or decreased in one or more increments of 1/8 of 1%, but a maximum of ½ of 1% is permitted.

Although there is no specific authority limiting the use of the revenue derived from the tax, Section 379A.081(a) allows the municipality to levy the tax for the benefit of the corporation. The municipal corporation's purpose is to develop and implement programs as described by the chapter. Among the authorized programs, are the following:

- Job training, including long-term job training and in-training support service grants;
- Early childhood development that prepares each child to enter school and make each child ready to learn after completing the program and that provides education services;
- After-school programs for primary and secondary schools;
- Establishing provisions of funding accredited postsecondary education institutions, including public and private junior colleges, public and private institutions of higher education and public and private technical institutions, to be used to aware scholarships;
- Promotion of literacy; and
- Any other undertaking that the board determines will directly facilitate the development of a skill workforce.

Additionally, municipal corporations are allowed to accept donated property, may develop or use land, building equipment, facilities, and other improvements in connection with a program described above, or may dispose of property or an interest in property.

As of August 31, 2002, the City of Coppell is the only city that has adopted a sales and use tax for the benefit of a municipal development corporation. The City of Coppell approved the adoption of the tax on August 11, 2001.[88]

HEALTH SERVICES

Hospital District

A hospital district is authorized through various chapters in the Health and Safety Code, primarily Chapters 281, 283, and 285, to impose an ad valorem tax and to collect a sales and use tax. Imposition of the tax may be in increments of 1/8%, with a minimum tax of 1/8 of 1% and a maximum tax of 2%. Additionally, a district may not adopt a tax or increase the rate of the tax if as a result of either, the combined rate of all sales and use taxes imposed by the district and other political subdivision having territory in the district would exceed 2% at any location in the district. The district is also authorized, at an election to change the rate of its tax or abolish the tax.

Revenue from this tax may be used by the hospital district for any purpose for which the ad valorem tax revenue of the district may be used. Districts that have issued or assumed bonds payable from taxes are allowed to impose a tax for the benefit of the district on all property subject to district taxation. Therefore, revenue from sales and use taxes, like ad valorem tax revenue, may be used to create an interest and sinking funds for bonds issued by the district, to provide for the operation and maintenance of the hospital or hospital system, and to make improvements and additions to the hospital system, including the acquisition of necessary sites.

In the case of a district where all or a majority of the district's territory is located in a county or counties with a population of 75,000 or less, majority voter approval at an election is required to impose a sales and use tax. The revenue from this tax may be used to pay the indebtedness issued or assumed by the district, and the maintenance and operating expense of the district.

Emergency Service District Sales and Use Tax

Chapters 775 and 776 of the Health and Safety Code address the imposition and use of sales and use taxes in an emergency service district. Section 775.0752 allows emergency service districts to adopted, change, or abolish its sales and use tax at an election. These districts are authorized by Article III, Section 48-e, of the Texas Constitution, to provide emergency services, among them medical services, emergency ambulance services, rural fire prevention and control services, or other

[88] "Better Jobs Act: Letter to Legislature", Texas Comptroller of Public Accounts, September 13, 2002.

emergency services authorized by the Legislature. These types of district may impose the tax at a rate of ½%, 1%, 1½%, or 2%. As with the other types of districts, a tax may not be adopted nor increased if as a result of the adoption or increase a combined rate of all sales and use taxes imposed by the district and other political subdivisions would exceed 2% at any location in the district. Revenue from this tax may also be used for any purpose for which ad valorem tax revenue of the district may be used. Section 775.0741 authorizes districts to use ad valorem tax revenue for bond indebtedness.

As for emergency service districts located in counties with populations of 125,000 or less the requirements are the same, including the use of sales and use tax revenue for any purpose ad valorem tax revenue is used. Aside from authorizing the use of ad valorem tax revenue for the use of the district's support, Chapters 775 and 776 do not provide for specific uses for ad valorem tax revenue collected by an emergency service district.

MUNICIPAL AND COUNTY SALES AND USE TAXES

Municipal Sales Taxes

Chapters 321 through 325 of the Tax code authorizes a variety of municipal, county, and special purpose taxing authority sales and use taxes. Chapter 321 governs the general provisions of municipal sales and use tax. Under section 321.101 a municipality is authorized, with voter approval, to adopt or repeal a sales and use tax. Municipalities are also authorized, with voter approval, to adopt or repeal, and along with, reduce and increase an additional sales and use tax. There are however, certain municipalities that are disqualified from adopting the additional sales and use tax if they are located within boundaries of rapid transit authority created under Chapter 451 and 452 of the Transportation Code. Additionally, authorities created under the aforementioned chapters are prohibited from imposing a tax, a provided by for those chapters, if within the boundaries of the authority a municipality has already adopted an additional sales and use tax as provided by section 321.101 of the Tax Code. Additionally, a municipality may not adopt or increase a sales and use tax or an additional sales and use tax under this section if as a result of the adoption or increase, a combined rate of all sales and use taxes imposed by the municipality and other political subdivisions would exceed 2% at any location in the municipality.

The sales tax is imposed on the receipts from the sale at retail of taxable items within the municipality at the rate of 1% and at the same rate on the receipts from the sale at retail within the municipality of gas and electricity for residential use. A municipality that has adopted the additional municipal sales and use tax, may impose the tax at the rate approved by the voters. The rate, when the tax is adopted must be equal to either 1/8, 1/4, 3/8, or ½ of 1%. The rate may be reduced in one or more increments of 1/8 of 1% to a minimum of 1/8 of 1% or increased by the same manner to a maximum of ½ of 1%, or the tax may be abolished.

A municipality that has adopted the tax authorized under Chapter 321 can also impose an excise tax on the use, storage, or other consumption within the municipality of taxable items purchased,

leased, or rented from a retailer during the period that the tax is effective within the municipality. The city may also impose an excise tax on the use, storage, or other consumption of gas or electricity for residential purposes and purchased from any retailer within the municipality. The rate of both these excise taxes is the same as the rate of the sales tax portion of the tax. Section 321.105 does lists various exemptions to the applicability sale and use tax.

The sales and use revenue received by the municipality may be used for the benefit of the municipality, and as such may be used for any purpose for which the general funds of the municipality may be used. The municipality may not however pledge this revenue for the payment of bonds or other indebtedness. Revenue from the collection of the additional municipal sales and use tax must be used for debt service. Any revenue in excess of the amount of revenue needed for debt service may be used for any municipal purpose consistent with the municipal budget.

Fire Control District Tax

An additional tax provision is carved out of the general municipal sales and use tax for fire control districts. Subject to an election, a municipality is authorized to both create a fire control, prevention, and emergency medical services district, and adopt a tax for purposes of financing the operation of the district. The proposition for adopting the tax and for creating the district shall be submitted at the same election. For purposes of section 321.101, the section granting the general authority for municipal sales taxes, a tax under this section is not construed as an additional sales and use tax.

The rate for a tax under this section may be decreased in increments of 1/8 of 1% by order of the board of directors of the district. The rate of a tax may be increased in increments of 1/8 of 1%, not to exceed a total tax rate of ½%, by order of the board of directors of the district if approved by the voters at an election called on the question of increasing the tax rate. For purposes of the tax imposed under this section, a reference in this chapter to the municipality as the territory in which the tax or an incident of the tax applies means only the territory located in the district, if that district is composed of an area less than an entire municipality.

The revenue from the tax may be used only for the purpose of financing the operation of the fire control, prevention, and emergency medical services district. Remittance of the tax revenue is done by the Comptroller of Public Accounts who includes this tax as part of the regular allocation of other municipal tax revenue collected. The municipality then remits the tax revenue to the district.

County Sales and Use Tax

Chapter 323 is the governing authority for county sales and use taxes. A qualified county is authorized, with voter approval, to adopt or repeal a county sales and use tax. Counties are qualified if no part of the county is located in a transit authority created under Chapter 451 or 452 of the Transportation Code. The county can use the tax revenue for the use and benefit of the county and shall be used for the replacement of property tax revenue lost as a result of the adoption of taxes authorized under the chapter.

Revenue in excess of that used to replace lost property taxes must be used for the reduction of indebtedness of the county, after which any remaining revenue may be used for any purpose for which the county general revenue may be used. At no time however, can a county pledge anticipated revenue from this source to secure the payment of bonds or other indebtedness for a period longer than one year.

Crime Control District Tax

As in the municipal section discussed above, an additional tax provision is carved out of the general county sales and use tax for crime control and prevention districts. Section 323.105 of the Tax Code authorizes a county to create a crime control and prevention district, and to adopt a sales and use tax in the area of the district for the sole purpose of financing the operation of the district. The rate adopted under may be decreased in increments of 1/8 of 1%, by order of the board of directors of the district, and may be increased in the same increments so long as it does not exceed a total rate of ½% by order of the board and with voter approval.

The Comptroller of Public Accounts remits to the county the amounts collected at the rate imposed as part of the regular allocation of county tax revenue collected, if the district is composed of the entire county. The county is then responsible for distributing to the district that portion of the county sales and use tax that is to be used for the financing of the district. If the district is smaller, then the Comptroller shall remit the tax revenue directly to the district.

County Health Services Sales and Use Tax

Chapter 324 of the Tax Code authorizes a county having a population of 50,000 or less, to adopt or abolish a county health services sales and use tax, at a rate of ½%, at an election held in the county. A county may not adopt a tax under this chapter if as result of the adoption the combined rate of all sales and use taxes imposed by the county and other political subdivision having territory in the county would exceed 2% at any location in the county.

The revenue from the tax may be used only to provide health services in the county. The county imposing the tax may allocate all or part of that revenue to a county hospital authority or a hospital district having the same boundaries as the county; or a public health district in which the county participates.

County Sales and Use Tax for Landfill and Criminal Detention Center

Chapter 325 of the Tax Code authorizes a county having a population of 48,000 or less that borders the Rio Grande and containing a municipality with a population of more than 22,000, to adopt or abolish a sales and use tax at an election held in the county. A county may not adopt a tax if as a result of the adoption the combined rate of all sales and use taxes imposed by the county and other political subdivisions having territory in the county would exceed 2% at any location in the county.

The revenue from the tax may be used only to build, operate, or maintain a landfill and a criminal detention center in the county. Section 325.021 (d)-(f), provides additional limits on the use of sales tax revenue collected. Among those limitations are that the portions of the tax necessary for the operation of the landfill and the portion necessary for debt services for criminal detention center bonds, are dedicated solely to their respective purposes, and that any remaining tax revenue not dedicated to the operation of the landfill or criminal detention center debt service must be used for property tax reduction.

RECOMMENDATIONS

The Ways and Means Committee recommends to the 78th Legislature:

- Allow local political entities to transfer dedicated revenue, from sales and use tax, from one statutorily authorized dedicated use to another statutorily authorized dedicated use, in a single ballot proposition. Presently, if a city with a statutorily authorized hospital district and a statutorily authorized municipal development corporation seeks to transfer part of the sales and use tax that is dedicated to the hospital district towards the municipal development corporation, it would be required to use two ballots: one to reduce the tax from the hospital district, the second raising the tax for the municipal development corporation. By streamlining the system, local communities are better able to accommodate their changing demands for services.

Appendix

CHARGE 3

Continue to study the economic impact of internet commerce on state and local tax revenues, and monitor federal legislation and action relating to Internet taxation, including state participation in multi-state efforts to simplify the administration of sales and use taxes.

BACKGROUND

During the 77th Legislative Session, House Bill 1845 was passed. This legislation allows Texas to participate as an voting participant in implementing the Streamlined Sales Tax Project (SSTP). Texas is one of 36 voting states, that along with 3 observing states, is participating in the federal Streamlined Sales Tax Project (SSTP) which has the purpose of designing a simplified sales collection system that can be used by traditional retailers as well as sellers involved in e-commerce. The legislatures of the voting participant states have enacted enabling legislation or their state executives have issued executive or similar orders authorizing their participation, nonvoting participants do not have a formal commitment of their state legislatures or their chief executives but are participating so as to be aware of the SSTP's work.[89]

Presently, states cannot require companies to collect sales and use taxes from customers in that state unless the company has a physical presence within the state. If a company has no physical presence, a customer is required to pay taxes directly to the state on anything purchased from a catalog or from the Internet. The concern is that as sales over the Internet expand, each state faces further erosion of its tax base. The expressed goal of SSTP is to substantially reduce the tax collection burden on retailers by creating uniformity among states and by simplifying audit and administrative procedures with the use of emerging technologies. If the burden on retailers is reduced, out-of-state retailers may voluntarily collect use taxes and remit them to member states. Thus, states will be able to capture revenue that is currently uncollected. House Bill 1845 established the Simplified Sales and Use Tax Administration Act to reflect SSTP's proposed uniform act.

The SSTP was originally organized in March 2000, and originally sponsored by four organizations: the National Governs' Association, the National Conference of State Legislatures, the Federation of Tax Administrators, and the Multistate Tax Commission. The SSTP has been conducting its work through a steering committee with members from various states and with four separate work groups assigned to work on various issues of concerns. Each state sent four delegates to participate in adoption of the agreement. These work groups have met bi-monthly since March 2000 to develop their work products. In addition to the SSTP members, businesses and business associations have been active participants as well.[90]

On November 12, 2002, delegates adopted an interstate agreement, however this agreement is still a work in progress.[91] The agreement is what all states will look at to try conform their statutes in order to continue participating as signatories to the agreement. As stated previously, Texas is one

[89] Diane L. Hardt, Douglas L. Linhold, and Joseph R. Crosby, "A Lawmaker's Guide to the Streamlined Sales Tax SSTP", Journal of State Taxation, Volume 21, Number 2.

[90] Ibid.

[91] Testimony of Eleanor Kim, Field Operations-Audit Division, Texas Comptroller of Public Accounts, Ways and Means Hearing, November 25, 2002.

of 36 states that have enacted legislation authorizing their state revenue departments to participate in the SSTP. Now, Texas, along with the other states, need to enact laws to simplify their state sales and use tax laws and make them more uniform with the laws of the other states.

There are currently four states that have already changed their laws in compliance with the agreement. Texas in order to be one of the ten states that are necessary to make the agreement binding and take effect, must change its laws, rules, and regulations in order to be with substantial compliance with agreement. In doing so, Texas would continue to have input in what the final model will look like.[92]

The Comptroller is not too concerned about Texas' ability to comply and participate, because Texas' Sales and Use Statutes is one of model schemes that is being looked at by the SSTP. Therefore, there would not need to be any drastic changes in order for Texas to be in compliance.[93]

Changes

As stated, in order for the agreement to become binding and take effect, 10 states and at least 20% of the total population of all participating states must pass statutes that substantially conform with the agreement. This is a recent change from what was previously proposed, a requirement that only 5 states comply in order for the agreement to take effect. For a comprehensive summary of the SSTP and its proposal refer to "A Lawmaker's Guide to the Streamlined Sales Tax SSTP," Journal of State Taxation, which has been reprinted and attached as an Appendix to this charge.

The Comptroller has determined that the following are the areas in which Texas is not in compliance with the agreement and would need to change.

Sourcing Change

Sourcing refers to determining for which state and local jurisdiction the tax is to be collected.[94] Currently in Texas, cities and counties source the tax at the origin of the sale. Much like an over the counter sale. The SSTP proposes that sellers be required to source sales of property, services, and digital goods on a destination basis.[95] This most commonly occurs when an item is purchased at one location or taxing jurisdiction and then shipped somewhere else. If the shipping address is

[92] Ibid.

[93] Ibid.

[94] Diane L. Hardt, Douglas L. Lindholm, and Joseph R. Crosby, "A Lawmaker's Guide to the Streamlined Sales Tax SSTP," Journal of State Taxation, Volume 21, Number 2.

[95] Ibid.

unknown to the seller, than the purchaser's address is the next location used.[96] If however, none of these are known, then the sale is sourced to the address for the purchaser obtained during the sale transaction, including the address of the purchaser's payment of instrument. If none of these are known, than the sale is sourced to the origin of the sale. A destination based approach was preferred because it is the approach used by a majority of the states for sourcing intrastate sales.[97]

The Comptroller's office does not consider this change as an overall gain or loss for the state as a whole, but rather a shifting of local revenue among different jurisdictions. The Comptroller recognizes that there would be an effect to local jurisdictions, but at the time of this report, no figures were available. Compliance however, would serve in increasing the revenue the state receives from remote sellers since they use destination when dealing with interstate commerce.[98]

Taxes on Leases and Rentals

This change was added recently, and according to the Comptroller, is likely to result in a minor revenue net loss to the states.[99]

Texas currently sources leases based when the equipment was first received in the state and a lease is executed. The state currently taxes on the entire life of a lease. Therefore, if a five year lease is executed, the state collects on the monthly payments for the full five year term, regardless if the equipment is no longer in the state.

The SSTP proposes that location of equipment be the new method of taxation. Therefore, if equipment moves to another state, then the new state can collect tax. As stated, the Comptroller has determined that a slight revenue loss may occur, however any loss would be offset by the revenue of new leases coming in as a result of the agreement.[100]

Thresholds

Thresholds are an exclusion from tax or the application of a different tax rate to purchases above or

[96] Ibid.

[97] Ibid.

[98] Testimony of Eleanor Kim, Field Operations-Audit Division, Texas Comptroller of Public Accounts, Ways and Means Hearing, November 25, 2002.

[99] Ibid.

[100] Ibid.

below a set level.[101] The SSTP requires that by January 1, 2006, all thresholds must be eliminated. This proposals was developed for the benefit of the business community because threshold are difficult to administer for sellers.

Currently in Texas, information services and data processing services allow for the first 20% of the amount to be exempt. Elimination of the threshold means that Texas must either make the total amount exempt, or make it 100% taxable.[102]

The Comptroller is presently drafting the necessary legislative changes to be introduced in a bill during the 78th Legislative Session. Due to the minimal changes that need to be made to Texas' statutes, the Comptroller considers the bill will be more of a house keeping measure. Recognition of any final model will need to be addressed in future legislative sessions.[103]

The Comptroller has determined that future participation in simplifying and modernizing the sales tax system is beneficial to the state because if it works, there will be uniformity and compliance. Of particular benefit will be that remote sellers will start collecting sales and use tax which they are currently not collecting. As evidence of this probability, there are already some Internet companies who in light of the SSTP are already starting to voluntarily collect the tax as a precaution to avoiding any future liability.[104] Ultimately whether there is a financial net gain or net loss, depends on what a state legislature does. The SSTP does not dictate what a state can or cannot tax, but rather is an attempt to give uniformity in definitions and give the state legislature the options of which way they want to go.[105]

RECOMMENDATION:

The House Ways and Means Committee recommends to the 78th Legislature:

- Seriously consider the proposed model legislation and look at the advantages and disadvantages to Texas. The legislature should consider however, that by being one of the first ten states to adopt this language, Texas would be taking a leadership role which may benefit the passing the whole matter nationwide.

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[101] Diane L. Hardt, Douglas L. Lindholm, and Joseph R. Crosby, "A Lawmaker's Guide to the Streamlined Sales Tax, SSTP," Journal of State Taxation, Volume 21, Number 2.

[102] Testimony of Eleanor Kim, Field Operations-Audit Division, Texas Comptroller of Public Accounts, Ways and Means Hearing, November 25, 2002.

[103] Ibid.

[104] Ibid.

[105] Ibid.

Appendix

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A Lawmaker's Guide to the Streamlined Sales Tax

DIANE L. HARDT, DOUGLAS L. LINDHOLM, AND JOSEPH R. CROSBY

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The Streamlined Sales Tax SSTP (SSTP) is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The SSTP's proposals include tax law simplifications, more efficient administrative procedures, and using emerging technologies to reduce the burden of tax collection. The SSTP's proposals are focused on improving sales and use tax administration systems for both Main Street and remote sellers and for all types of commerce.

The 36 states that are voting participants in the SSTP are shown in Table 1. The legislatures of these states enacted enabling legislation or their state executives issued executive or similar orders authorizing their participation. The District of Columbia is also a voting participant in the SSTP. Three other states are nonvoting participants in the SSTP .They do not have the formal commitment of their legislatures or their chief executives but are participating so as to be aware of the SSTP's work.

TABLE 1. Participating States

Alabama	Michigan	Rhode Island
Arizona	Minnesota	South Carolina
Arkansas	Mississippi	South Dakota
Florida	Missouri	Tennessee
Illinois	Nebraska	Texas
Indiana	Nevada	Utah
Iowa	New Jersey	Vermont
Kansas	North Carolina	Virginia
Kentucky	North Dakota	Washington
Louisiana	Ohio	West Virginia
Maine	Oklahoma	Wisconsin
Maryland	Pennsylvania	Wyoming

The SSTP was organized in March 2000, after several earlier attempts to simplify sales tax administration. (The SSTP's long history is explained below, in Historical Perspective on the Project.) The SSTP was initially sponsored by four organizations: the National Governors'

Association, the National Conference of State Legislatures, the Federation of Tax Administrators, and the Multistate Tax Commission. These four groups identified the features of the SSTP's Streamlined Sales Tax System, which are listed in Table 2.

TABLE 2. Uniformity Features

1. Uniform Sourcing Rule
2. Standardized Geographic Coding System for Local Rates
3. Local Rate Simplification
4. Uniform Required Notice and Limited Frequency of Rate Changes
5. Uniform Product Codes for Exemptions by Product Category
6. Uniform Definitions
7. No or Minimal Sales Tax Returns or Reporting Requirements for Participating Sellers
8. Central One-Stop Registration System
9. Simplified Exemption Administration for Use and Entity Exemptions
10 Uniform Treatment of Bad Debts
11. Systems Checks of Sellers and Minimal Exposure to Audits
12. Uniform Audit Procedures
13. State and Local Taxes Remitted at State Level Only, with State Responsible for Distributing Funds to Local Governments
14. Voluntary Registration Not a Factor in Determining Nexus for Income or Other Taxes; Terms and Conditions for Past Liability Relief
15. Uniform Rounding Rules
16. Privacy Protections
17. Joint Certification of Software
18. State Compensation for System

The SSTP has conducted its work through a steering committee led by co-chairs Diane Hardt of the Wisconsin Department of Revenue and Charles Collins of the North Carolina Department of Revenue. Other steering committee members come from states of different sizes including Kentucky, Missouri, New Jersey, Pennsylvania, South Dakota, Texas, and Utah. The SSTP assigned the features of the Streamlined Sales Tax System to four work groups: (1) Tax Base and Exemption Administration; (2) Tax Rates, Registration, Returns, and Remittances; (3) Technology, Audit, Privacy, and Paying for the System; and (4) Sourcing and Other Simplifications. The work groups have met monthly since March 2000 in developing their work products.

Businesses and their association--including national grocers, department stores, manufacturers, technology companies, telecommunications companies, airlines, leasing companies, printers, direct marketers, electronic commerce businesses, and accounting firms--have actively participated in the SSTP, which has focused on simplifications for multistate sellers because of the complexities these sellers face in complying with multiple state and local sales tax laws and jurisdictions. The SSTP has maintained, however, that any solutions must also work for small brick-and-mortar stores, that represent the majority of the sales tax collectors and filers in any state.

Lawmakers need to be aware of the simplifications and uniform laws recommended by the

SSTP. Many legislatures have enacted legislation authorizing their state revenue departments to participate in the SSTP's multistate discussions but will be asked to enact laws in 2002 and 2003 to simplify their state sales and use tax laws and make them more uniform with the laws of other states. Lawmakers should also note that SSTP participants have painstakingly deliberated on each of the issues and have always tried to balance simplification, flexibility for policymakers, and revenue impacts on governments in arriving at the proposals.

STATE TAX ADMINISTRATION

Most states administer their state and local sales and use taxes. The home-rule states are the exception. Alabama, Arizona, Colorado, and Louisiana either constitutionally or statutorily allow their local jurisdictions to legislate their own tax bases, develop their own ta returns and filing requirements, and audit their own taxes.

Local governments in Alabama that currently administer their own taxes have tried both state and local tax administration in recent years. When they moved from state administration to local administration, there was a dramatic increase in collections for local jurisdictions. The SSTP's position is that each state and the local jurisdictions within that state need to work out the optimal collection and audit procedures for all jurisdictions in the state; however, businesses should still be required to file only one tax return per state per reporting period. States can attend to the distribution of the revenues to their local governments.

SINGLE STATE AND LOCAL TAX BASE

Most states have a single tax base for the state and all of the local jurisdictions within that state, except where prohibited by federal law. (For example, federal law prohibits local taxation of direct-to-home satellite services.) Any particular item or service is taxable or exempt at both the state and local level.

Under current law there are two exceptions to the single tax base:

1. "Home-rule" states either constitutionally or statutorily allow their local jurisdiction to determine what is taxable within that jurisdiction. Alabama, Arizona, Colorado, and Louisiana have separate tax bases for local jurisdictions.
2. A few states statutorily provide for a local tax base that differs from the state tax base. For example, food may be exempt from the state sales tax but subject to a local tax; residential electricity may be taxed at the local level but not by the state.

Multistate sellers have advised the SSTP that the single most difficult issue in sales tax administration is dealing with multiple tax bases within states. In fact, these sellers have indicated they devote more resources to administering sales taxes in the handful of home-rule states than in all of the other states combined.

The SSTP has taken the position that all participating states must work toward a single state and local tax base and achieve that uniformity by December 31, 2005. The SSTP has made an exception for sales and use taxes levied on the transfer of motor vehicles, aircraft, watercraft, modular homes,

manufactured homes, and mobile homes. The SSTP made this exception because of concerns about the various kinds of tax levies on these items a d because of concerns about shifting revenues between state and local governments.

The business co unity has taken the position that participating states with separate state and local tax bases should be forced to harmonize those bases. Further, because of the administrative difficulty of dealing with separate state and local tax bases, businesses are recommending elimination of the SSTP's phase-in period.

UNIFORM DEFINITIONS WITHIN TAX BASES

Uniform definitions represent one of the most fundamental components of the Streamline Sales Tax System. The SSTP envisions a glossary of uniform definitions from which a state would define its tax base. The glossary would include the universe of items or services that could be taxed by a state. Legislatures would determine what is taxable or exempt but agree to use the uniform definitions. Because businesses now operate in a borderless and even global economy, uniform definitions would simplify multistate compliance by allowing definitive taxability determinations. In fact, tax software could be coded based on a matrix of states, defined property and services, and taxability determinations by the state.

As states move from their current definitions to the SSTP's definitions, a certain amount of impact on state revenues is inevitable. It is the intent of the SSTP, however, to provide states with the ability to mirror their existing tax bases closely through uniform definitions. State legislatures should not view participation in the SSTP as a means of raising, or lowering, state tax revenues.

There certainly have been questions raised as to why states need uniform definitions. So we have suggested that technological advances should enable states to ave various definitions. Some state legislators have indicated they do not want to get boxed in by uniform definitions. Some businesses supported the concept of uniform definitions until the SSTP started working on uniform definitions affecting their industry.

Businesses that collect and remit sales taxes for the states will not accept technology as a substitute for uniform definitions, and with good reason. They are familiar with current software packages and their limitations. They know how many employees are required to make accurate sales tax law determinations, even with all of the software packages and research tools currently available. And they know that incorrect sales tax determinations in their multi state businesses often result in audits, additional taxes due, and in some cases, class action lawsuits.

The SSTP has worked with the business community to identify sales tax terms and definitions most in need of uniformity and has made them a first priority. Ultimately, the SSTP would expect to define the universe of items and services within state tax bases and product exemptions. The SSTP does not expect to define use-based exemptions (e.g.,manufacturing exemptions).

A participating state is expected to adopt all items specifically mentioned in a definition. A participating state may not vary from that definition except as provided in the agreement between the participating states. For example, the SSTP has defined food and food ingredients and various subcategories of food, including candy, dietary supplements, soft drinks, and prepared food. A participating state may choose to tax all food and food ingredients, which include candy, dietary supplements, soft drinks, and prepared food. On the other hand, a participating state may choose to

exempt food and food ingredients as defined by the SSTP but tax one or more of the subcategories as defined by the SSTP. A participating state may not, however, choose to tax a subcategory such as candy and exempt a particular kind of candy that falls within the subcategory .

The SSTP has also defined four mutually exclusive categories of clothing: (1) clothing, (2)clothing accessories, (3) sport or recreational equipment, and (4) protective equipment. A participating state may tax or exempt any or all of these, four categories but may not vary from the definitions of these categories. Therefore, a participating state may not choose to exempt one item within the category of protective equipment.

The SSTP has also defined purchase price, retail sale, sales price, and delivery charges. Other definitions completed include those for tangible personal property, computer software, prewritten computer software, prosthetic devices, durable medical equipment, mobility enhancing equipment, prescription drugs, over-the-counter drugs, and lease or rental.

TAX RATE SIMPLIFICATIONS

Some would say that a truly streamlined sales tax system would provide for one rate per state with no variances for local jurisdictions. Thus, sellers would have to contend only with one rate per state for the District of Columbia and each of the 45 states that impose a sales tax. States could distribute the sales tax collections to their local jurisdictions in any manner they chose.

This simple tax rate structure was abandoned early in the SSTP. Local governments are increasingly reliant on local sales taxes and may have issued bonds that are backed by the local tax revenue stream. Local government input to the SSTP suggested that a single tax rate structure would not be accepted politically. The business community, while preferring one rate per state, recognizes that technology is available to deal with multiple rates if there are restrictions on the frequency of rate changes, databases to help with rates, and a single tax base per state.

The SSTP's rate simplifications include the following:

1. States may have only one state tax rate on items of personal property and services after December 31, 2005.
2. States are encouraged to provide advance notice of rate changes and limit the effective date of rate changes to the first day of a calendar quarter.
3. States with local jurisdictions that levy sales and use taxes must not have more than one sales tax rate or more than one use tax rate per local taxing jurisdiction. If the jurisdiction levies both a sales and use tax, the rate must be identical.
4. States and local jurisdictions may not have caps or thresholds on the application of sales and use tax rates or exceptions that are based on the value of a transaction or item after December 31, 2005.
5. Local tax rate changes will be effective only on the first day of a calendar quarter after a minimum of 60 days' notice to sellers.
6. Local tax rate changes applicable to catalog purchases will be effective on the first day of a calendar quarter after a minimum of 120 days' notice to sellers.
7. States with local jurisdictions will provide a database that describes rates for all of the

jurisdictions levying taxes in the state. The databases will also include rate and boundary changes for all taxing jurisdictions.

8. States will assign tax rates and jurisdictions to each nine-digit zip code. States will work together to develop an address-based system for assigning rates and jurisdictions.
9. Tax rate limitations and limitations on caps and thresholds do not apply to sales and use taxes levied on the transfer of motor vehicles, aircraft, watercraft, modular homes, manufactured homes, and mobile homes.
10. States and local jurisdictions will relieve sellers and certified service providers (CSPs) from liability for having charged and collected the incorrect amount of sales or use taxes if the sellers or CSPs relied on erroneous data provided by a state on tax rates, boundaries, or taxing jurisdiction assignments.

The most controversial requirement is that states may have only one state rate to e applied to all taxable property or services. A number of states have multiple state rates. The SSTP has recommended that states consider alternatives such as income tax credits and refunds to taxpayers to get to one state rate and a streamlined sales tax system for sellers.

UNIFORM SOURCING RULES

Sourcing refers to determining for which state and local jurisdiction, if any, tax is to be collected. The SSTP has proposed that sellers be required to source sales of property, services, and digital goods on a destination basis.

Under a destination-based rule, the seller would source the sale to the seller's business location for over-the-counter transactions and to the customer's shipping address for other transactions. If the "shipped to" address is not known to the seller, the next level in the sourcing hierarchy is the purchaser's address as maintained by the seller in the normal course of business. When none of these locations is known the sale is sourced to the location indicated by an addressed for the purchaser obtained during the consummation of the sale, including the address of the purchaser's payment instrument if no other address is available. When the destination rules do not apply, the sale is sourced to the origin of the sale.

The destination rules may not adequately address a situation in which a product can be accessed or used by several persons in different locations at once, such as software accessed by remote employees, or a database accessed by various offices of a multistate company. The SSTP has proposed a multi points of use (MPU) procedure in these cases. When a digital good or service is concurrently available for use in more than one jurisdiction, the purchaser may deliver to the seller a MPU exemption form. The seller will then be relieved of any obligation to collect the tax and the purchase will be required to pay the tax by using a reasonable and consistent method of apportionment that is supported by the purchaser's business records.

Lawmakers of states with local taxes should be aware that the SSTP is recommending a destination approach for both state and local taxes. A majority of the states use destination for sourcing intrastate sales. Thus, although the destination approach will mean a change in some states that use origin sourcing, the destination approach was the least disruptive choice in a simplified and uniform system. In addition,1he implementation of a different sourcing rule for intrastate sales and

interstate sales raises significant constitutionality issues. Since the sales tax is a tax on consumption, destination was the policy preference.

The SSTP has worked closely with telecommunications companies and printers to address their unique sourcing issues. Special rules have been developed for various telecommunications services. For mobile telecommunications services, the SSTP has followed the federal Mobile Telecommunications Sourcing Act. As of February 2002, the SSTP continued to work with printers in addressing their concerns.

SIMPLIFIED EXEMPTION ADMINISTRATION

There are three types of exemptions in sales tax law: (I) product exemptions, (2) entity-based exemptions, and (3) user-based exemptions. Product exemptions are easy to administer when the states have uniform definitions. For example, many states do not tax prescription drugs and sellers just do not collect tax on the products that fit the uniform definition for the exemption for prescription drugs.

The exemptions for entities and users are more difficult to administer. Sales tax law carries a presumption that sales of all tangible personal property are taxable unless specifically exempted by law. Entities and users who qualify for an exemption because of who or what they are or how they use a product need to prove they qualify for the exemption. The entities and users use exemption certificates for this purpose. For example a school must provide an exemption certificate to a seller to purchase school supplies or books without tax; a farmer or manufacturer must provide an exemption certificate to a seller to purchase machinery used in farming or manufacturing without tax.

The SSTP has identified numerous ways to improve sales tax administration related to exemptions. The business participants have been most helpful in developing the new procedures and proposed law. All participants agree that the SSTP has achieved radical simplification in exemption processing requirements while improving the means for states to verify exemptions claimed.

There are two components to the simplifications:

1. Uniform exemption certificates (electronic where possible); and
2. Relief for sellers from any tax if a purchaser improperly claims an exemption, as long as the seller obtains the required identifying information of the purchaser and the reason for claiming the exemption at the time of purchase.

Under current laws in many states, sellers can be held responsible for nonpayment of tax when a purchaser incorrectly claims an exemption. Sellers have been the enforcers of sales tax law even though it is often difficult to determine whether an exemption is being properly claimed. In recent years, several states have repealed these good-faith requirements on sellers without major compliance problems. Purchasers are held responsible for nonpayment of tax when it is due.

Lawmakers should be aware that states may need to amend their laws regarding exemption certificates so that the states collect the uniform identifying information of the purchaser and the reason for claiming the exemption. Purchasers will not be required to sign an exemption certificate unless a paper certificate is used. States may elect to use a system in which a purchaser exempt from

payment of tax is issued an identifying number that must be presented to the seller at the time of purchase. Sellers will then provide information on exempt purchases to the tax departments on a regular basis. The tax departments obtain a new means of verifying exemptions claimed.

The SSTP is currently developing one uniform exemption certificate. This uniform check-the-box certificate will replace the multiple exemption certificates used by many states.

CAPS AND THRESHOLDS

Several states or their local governments have caps in their sales and use tax laws. Dollar caps are limits on the amount of tax charged on a purchase. Rate caps are limits on the rate that can be applied when determining the tax amount.

Examples of dollar and rate caps follow:

1. Florida provides for a local sales and use tax on the first $5,000 of the purchase price of a single item.
2. South Carolina provides a sales and use tax dollar cap of $300 on the purchase of an automobile.
3. Texas has a rate cap of 8.25 percent on state and local tax levies.

Thresholds are an exclusion from tax or the application of a different tax rate to purchases above or below a set level. For example, New York exempts all clothing priced below $110; Tennessee taxes airplanes at 6 percent on a purchase price up to $100,000 and 3 percent on a purchase price exceeding $100,000.

The SSTP has proposed the phaseout of caps and thresholds on state and local sales and use taxes after December 31, 2005. These proposals were developed with the business community in mind. Sellers have informed the SSTP that caps and thresholds are difficult to administer.

The SSTP has proposed that the restrictions on caps and thresholds not apply to sales or use taxes levied on the transfer of motor vehicles, aircraft, watercraft, modular homes, manufactured homes, and mobile homes.

SALES TAX HOLIDAYS

Sales tax holidays are temporary sales tax exemptions on certain items for a specific period of time. The tax holiday typically falls during if the traditional back-to-school shopping period. Most states with sales tax holidays place a ceiling on the price of eligible merchandise and exempt I purchases from state and local sales and use taxes. Currently, jurisdictions with sales tax holidays include Texas, Florida, Connecticut, South Carolina, Pennsylvania, Iowa, Maryland; North Carolina, and the District of Columbia. Florida, Maryland, and Pennsylvania require new legislation each year.

The two primary policy considerations set forth by proponents of sales tax holidays are tax relief and increased economic activity. Sales tax holidays are particularly important to states that border states with no sales taxes, lower sales tax rates, permanent exemptions on particular rates, or competing holidays.

From a sales tax administration p-perspective, sales tax holidays create numerous difficulties for both sellers and revenue departments. These administrative difficulties are especially pronounced

for multistate sellers. Catalog and Internet sellers have difficulty determining when a sale actually takes place. Most, if not all, states use transfer of title or possession to set the time of sale. For catalog or Internet sales, this occurs when an item is shipped. In many cases, neither the customer nor the seller knows the shipping date at the time of the order.

An additional level of complexity exists when the seller must determine the consumer's ultimate use of an item. For example, some states provide a sales tax holiday on "computers for home use." Catalog and Internet sellers do not have the face-to-face contact to ask questions about use.

There are many other complex issues regarding sales tax holidays that must be resolved, including questions about layaway purchases, exempt and taxable items that are packaged together, coupons and discounts, rainchecks, exchanges, shipping and handling charges, service charges, restocking fees, and back orders.

The SSTP's position is that sales tax holidays should not be allowed lin the Streamlined Sales Tax System. Brick-and-mortar sellers are divided on this proposal. Mail-order and Internet sellers support the prohibition of sales tax holidays.

CENTRALIZED REGISTRATION AND AMNESTY

The SSTP has proposed one online registration system that will allow sellers to register in all of the participating states. By registering in this system, the seller would agree to collect and remit sales and use taxes for all taxable sales into the participating states. The SSTP wants to make it easy for sellers to collect taxes voluntarily.

Registration with the central registration system and the collection of sales and use taxes in the participating states will not be used as a factor in determining whether the seller has nexus with a state for a business activity tax, such as the income or franchise tax.

The SSTP is promoting an amnesty for uncollected or unpaid sales and use taxes to a seller that registers to pay and/or to collect and remit applicable sales and use taxes on sales made to purchasers in a state. The amnesty is applicable to sellers that register within 12 months of the effective date of a state's participation in the Streamlined Sales Tax System. The amnesty is not applicable to sellers that were registered in a state in the 12-month period preceding the commencement of the state's participation in the system. The amnesty is also not available to sellers under audit or to sellers that owe sales and use taxes in their capacity as a buyer. States may allow amnesty in terms and conditions more favorable to the seller than what is provided in the agreement between the participating states.

UNIFORM RULES FOR RECOVERY OF BAD DEBTS

The SSTP has developed uniform rules for a deduction for the bad debts of a seller. To the extent a state provides a bad debt deduction to any other party (e.g., third-party assignments), the same uniform procedures will apply.

The bad debt deduction will be tied to the requirements of the Internal Revenue Code (Code). Sellers will be allowed to claim a deduction on the return for the period during which the bad debt is written off as uncollectible rather than being required to file refund claims for when the sale was reported. The statute of limitations for claiming the bad debt deduction will be the state's otherwise

applicable statute of limitations for refund claims; however, the statute of limitations will be measured from the due date of the return on which the bad debt can first be claimed.

TECHNOLOGY MODELS AND CERTIFICATION

The SSTP has proposed the integration of new technologies and simplified tax laws to improve the tax collection process. Three technology models are envisioned under the Streamlined Sales Tax System. A seller can choose one of these three technology models or can continue to use a traditional tax collection system. If a seller chooses one of the technology models as certified by the states, however, the seller will benefit from reduced liability and audit scope.

Model I is a CSP. Under this model, a seller selects a CSP as an agent to perform all of the seller's sales tax functions at no cost to the seller. The CSP then determines the amount of tax due, pays the tax to the states, and files returns with the states. The states will compensate the CSPs through a transaction fee, a percentage of revenues collected, or some combination of these. The states anticipate that several entities will be able to meet the requirements to be a CSP .

The CSP in this model is liable for the tax due unless there are errors by the states or fraud by the seller. The CSP is subject to audit and periodic system checks by the states. Any audit will be a joint audit performed on behalf of all of the states participating in the Streamlined Sales Tax System.

Model 2 is a certified automated system (CAS). A seller selects a CAS to calculate the amount of tax due on a transaction. Sellers benefit from the use of a CAS because they use standardized software that is certified by the states as accurate. The CAS in this model is subject to periodic system check. The seller is subject to audit on its tax remittance and return filing functions.

Model 3 is a proprietary system that is certified by the states as a CAS. This model accommodates large sellers with nationwide sales that have developed their own sophisticated proprietary automated sales tax systems. A seller with a proprietary system must agree to several conditions to obtain certification of its system. The seller must agree to process all its sales using the system, to meet an accuracy standard set by the states, to agree to a methodology for determining whether the system is meeting the established performance and. accuracy standards, and to allow the states to examine its system periodically.

The decision to se a CSP or CAS is entirely up to the seller. Sellers that do not find th use of a CSP or CAS relevant or beneficial can continue to calculate, pay, and report sales tax under their current procedures. These sellers will nevertheless benefit from the simplifications and uniformity achieved b the Streamlined Sales Tax System.

UNIFORM STANDARDS AND PROCEDURES

The SSTP has pr posed uniform audit standards and procedures for CSPs and sellers. The combination of certified software, uniform definitions, and common audit procedures should substantially reduce the tax administration burden on sellers in making correct determinations of the taxability of property and services.

The uniform audits standards and procedures are as follows:

1. Audits will be conducted by all participating states using statistical, sampling techniques in accordance with generally accepted audit standards.
2. States may conduct joint audits of CSPs and sellers. although Model 3 sellers with more complex tax systems and requirements may choose to be audited by individual states.
3. When joint audit are conducted and errors identified, audit information will be provided to each participating state. Each state will then determine an assessment or refund will be required. All states will issue he assessments or refunds within 90 days of the completion of th audit. States will continue to follow their own statutes of limitations.
4. Each participating state will provide a matrix of all definitions (uniform definitions and definitions specific to each state) of tangible personal property and services and the taxability of each item. Each state will be responsible for updating its matrix. CSPs and sellers will be held harmless from errors made by the state in its matrix.
5. States will provide resources to answer questions of sellers and CSPs on a timely basis.

Audit procedures will vary depending on the technology model used by a seller and the business of the seller. Audits will determine (1) the accuracy of the data used to determine sourcing of a transaction, (2) the mapping of property or services sold, (3) the identity of purchasers if exemptions were claimed, (4) the reasons for the exemptions claimed, (5) the accuracy of tax calculations, and (6) the accuracy of reporting. Sellers will remain subject to use tax compliance audits on their purchases.

DIRECT PAY PERMITS

Direct pay is an authority granted by a tax jurisdiction that generally allows the holder of a direct pay permit to purchase otherwise taxable goods and services without payment of tax to the supplier at the time of purchase. Suppliers are to be furnished with a written notification of the purchaser's direct pay authority. The permit holder timely reviews its purchases, makes a determination of taxability, and then reports and pays the applicable tax due directly to the tax jurisdiction. The permit holder's tax determinations and adequacy of payment are subject to audit by the tax jurisdiction.

The direct pay permit is helpful to many purchasers in the determination of their use tax obligation. Thirty-three of the 45 states with sales and use taxes provide for the direct payment of tax. Several states impose the obligation to collect taxes strictly on the seller. For these states, it may be difficult to implement a direct pay program.

The SSTP has proposed that participating states be required to provide direct pay permits to purchasers but that each state be allowed to set its own limits and requirements (types of businesses eligible, criteria, eligible transactions). The SSTP will also develop a single uniform direct pay permit application and certificate.

SELLER COMPENSATION FOR COST OF COLLECTION

The Vendor Allowance

Forty-five states and the District of Columbia impose sales and use taxes on purchases of tangible goods. In addition, 4,696 cities, 1 ,602 counties, and 1,113 other tax jurisdictions impose sales taxes. For a variety of reasons, state and local governments that impose sales taxes require an outside third party (i.e., sellers) to collect them at the point of sale from consumers. Sellers must then remit these taxes to state and local governments.

In an effort to offset a portion of the economic burden sellers incur as a result of this collection responsibility, many states allow sellers to keep a small portion of the tax collected (an "allowance"). Twenty-seven states currently provide some type of compensation to sellers. Eighteen states do not compensate sellers directly for any associated compliance costs. Sellers may also be able to offset the cost of collection in some states. Through interest earned on taxes that have been collected but not yet retired (the "float") or through other financial mechanisms. In other states, however, sellers are required to remit estimated taxes before collecting them; this results in a reverse float (i.e., the state earns interest on the seller's money).

The Joint Collection Cost Study

Several studies have been commissioned to ascertain exactly how much money sellers expend to collect sales taxes. These studies, however, have been widely criticized as biased because they were conducted either on behalf of states or on behalf of sellers. Recognizing the continued importance of this issue, and learning from the failure of past efforts, leader hip from the SSTP and the National Retail Federation, along with other representatives of both state and local government and the private sector have come together to create the Joint Collection Cost Study.

Although the simplifications proposed by the SSTP will, when implemented, significantly reduce the current collection burden, this study is important because sellers will continue to incur certain costs as a result of the collection responsibility imposed on them. This study will assist policymakers by providing answers to three critical questions:

1. How much does collecting the sales and use tax under the currents stem cost sellers?
2. How will the simplifications recommended by the SSTP reduce these costs?
3. What residual costs of collection remain in the simplified system?

The answers to these questions will help legislators determine the value of the SSTP for both the state and the business community and determine at what le el the seller allowance would have to be set to compensate sellers fa. ly for their costs.

A steering corn it tee has been created to oversee the development of the Joint Collection Cost Study. Steering committee members include,

1. From the public sector, the Federation of Tax Administrators, the Government Finance Officers Association, the Multistate Tax Commission, th National Conference of State Legislatures, and the SSTP and
2. From the private sector, the Council on State Taxation, the Direct Marketing Association, Federated Department Stores, J .C. Penney, the National Retail Federation, Radio Shack, and Wal-Mart Stores.

Other members of the public and private sectors are welcome to participate in the study's proceedings.

The Joint Collection Cost Study will determine the costs under the current sales and use ax system and the effect on those costs-including costs shifted from sellers to state governments -of changes to the system proposed by the SS .The study will also seek to identify the factors that generate the cost under various relevant conditions, including various types of sellers, different state and local sales tax regimes, different technological circumstances, and different states of implementation of a collection process. he target deadline for delivery of the study is December 31, 2002.

The study is intended to be a definitive one that will be widely recognized as objective and reliable, meeting the highest standards of research practicable d avoiding any issues of conflict of interest. It will exclude any tax other than generally applicable sales and use taxes collected on sales to un affiliated parties. It will not include costs borne by sellers of complying with use taxes on their own purchases or by states and localities in administering such taxes.

It is anticipated that the study will enable a comparison of the costs of collecting and administering sales and use taxes across a variety of factors. It will include an identification and analysis of factors in the operations of a seller and in the structure and administration of the sales and use tax that affect the costs of collecting, remitting, and administering sales and use tax s. The study will identify and analyze factors contributing to the cost f collecting, remitting, and administering sales and use taxes in sufficient detail to allow the impact of changes in various features of the tax a ministration process (e.g., those proposed by the SSTP) to be estimate.

The study should develop a model that will, when provided with data, measure the cost of collecting and administering sales and use tax. The model must be capable of modification so that it measures not only the current costs but also, when the recommendations of the SSTP are implemented, the costs borne under the changed system.

The study will also gather the data to be used with the model, populate the model with data, and present a final report with conclusions as to the cost of collection under the current system. The study will provide appropriately detailed descriptions of the methodology used to gather the data and build the model, as well as instructions and other inputs concerning methodology. The modified model can be used with available data or with additional data to measure the costs of collection under the Streamlined Sales Tax System and compare them with the costs under the current system.

The study should examine all incremental and identifiable costs of collecting and administering sales and use taxes from unaffiliated parties through the audit administration process. The study will exclude consideration of sellers' unrelated overhead costs and the compliance and administrative costs related to use taxes on a company's own consumption. In agreement with the steering committee, the study will separately identify and measure post-transactional costs which may be the subject of reasonable disagreement among policymakers. Examples of such costs include, but are not limited to, costs of defending class actions when a seller overcollects, interest and penalties on "human errors" when the seller has a reasonable error rate and costs of appeals and litigation. Existing seller compensation and benefits provided by states and localities to sellers and the time value to sellers of the use of sales tax collections will be measured.

TAXPAYER CONFIDENTIALI1Y AND PRIVACY

The SSTP has proposed a privacy policy to protect confidentiality rights of all participants in the Streamlined Sales Tax System and the privacy interests of consumers who deal with sellers that use CSPs.

The CSP will normally perform its tax calculation, remittance, and reporting functions without retaining consumers' personally identifiable information. Personally identifiable information will be collected, used, and retained only with respect to exempt purchasers to ensure the validity of exemptions from taxation that are claimed by reason of a consumer's status or the intended use of goods or services purchased. In addition, CSPs must provide consumers, including exempt purchasers, with clear and conspicuous public notice of their information practices, including what information they collect, how they collect it, how they use it, how long they retain it, and whether they will disclose it to the participating states. Such notice will be satisfied by a written policy statement accessible by the public on the official Web site of the CSP.

CSPs must provide technical, physical, and administrative safeguards to protect personally identifiable information from unauthorized access and disclosure. When personally identifiable information regarding an individual is retained by or on behalf of a participating state, the state will protect that information under its strict confidentiality laws and regulations. In addition, the state will provide reasonable access by such individual to his or her information in the state's possession and a right to correct any inaccurately recorded information.

ONE ROUNDING RULE

One would think the states could agree to one rounding rule to simplify sales tax administration, but agreement on this rule has proven to be a challenge. Why is one rounding rule appropriate? Businesses and technology companies that operate cash register systems or develop and maintain software need to know the rounding rules. If a multi state business with proprietary software can rely on one rounding rule for all states, its technology maintenance costs go down.

There are multiple components to a rounding rule: (1) the rounding algorithm (rounding up at one-half cent or some other point), (2) bracket systems provided in the law of a handful of states, (3) the number of decimal places used in computing tax due, and (4) taxing individual items or the aggregate when multiple taxable items are purchased at one time.

The SSTP worked with businesses and technology companies to understand the problems in rounding. Businesses are concerned that if states cannot agree on something as easy as rounding, the states will never agree on uniform definitions and other components necessary to a streamlined system. The businesses are also concerned about the costs of technology and the difficulty in keeping up with multiple state laws.

The SSTP has proposed the following rounding rules: (I) eliminate all bracket systems, (2) carry all tax computations to three decimal places, (3) allow sellers to elect one consistent method of computing tax on individual taxable items or the aggregate invoice of taxable items, and (4) provide one rounding algorithm. The fairest rounding algorithm for consumers is to round up to the nearest cent for anything one-half cent or more and round down for anything below one-half cent.

Two or three states have indicated that this proposal, and specifically the rounding algorithm,

will have a substantial negative revenue impact. The SSTP has proposed allowing states until December 31, 2005, to move to one rounding algorithm. This is the same deadline given to states for eliminating caps and thresholds, achieving one uniform state and local tax base, and eliminating multiple rates.

UNIFORM TAX RETURN

The SSTP proposes that a seller would file a single return per reporting period with each state. The return would include the detail for the taxing jurisdictions within that state and would be due no sooner than the 20th day of the month following the month in which a transaction occurred. Sellers using one of the SSTP's proposed technology models would file a simple tax return with limited data fields. All participating states would provide for electronic filing of returns by January 1,2003.

Sellers that register to collect taxes voluntarily for participating states would be allowed to file returns on an annual basis, with one exception. A participating state could require sellers that register to collect taxes voluntarily to file on a monthly basis if the seller collects $1 ,000 or more of combined state and local taxes for that state in the previous month.

The SSTP will develop a uniform state sales and use tax return for all states. Local jurisdiction information will be provided on attached schedules and tailored to a state's needs.

GOVERNANCE IN THE INTERSTATE AGREEMENT

The governance issue (i.e., defining the governing structures and operating parameters for the overall effort to simplify and streamline state sales tax systems) continues to be one of the more controversial areas of the SSTP. Effectively managing a joint state effort that seeks ultimately to enact legislation in the 45 states that currently levy a sales tax requires a delicate balance between the uniformity needed for effective simplification on the one hand and state sovereignty and federalism concerns on the other hand. Several governance models currently exist and the ultimate question of governance of the process has not yet been fully resolved. Three interrelated organizations will have input into final governance model: (1) the SSTP, (2) the National Conference of State Legislatures Executive Committee Task Force on State and Local Taxation of Telecommunications and Electronic Commerce (NCSL Task Force), and (3) the Streamlined Sales Tax Implementing States (SSTIS).

The Model Act and Agreement

The SSTP initially developed the Model Streamlined Sales and Use Tax Act and Agreement (Model Act and Agreement) to guide state participation in the streamlining effort. The Model Act essentially provides authorization for a state to enter into the Agreement with one or more states and to act jointly with other states toward its implementation. The Agreement, when finalized, will contain the substantive provisions necessary for implementing the Streamlined Sales Tax System.

The question of designing an appropriate governance model to manage the simplification process has been complicated by different versions of the Model Act and Agreement, as approved first by

the SSTP in December 2000, and second by the NCSL Task Force in January 2001. The NCSL Task Force, co-chaired by State Representative Matthew H. Kisber from Tennessee and State Senator Steven J. Rauschenberger from Illinois, initially developed the model state legislation that allowed authorization of state revenue departments to work together on the SSTP. It has since maintained an oversight role to the SSTP.

The SSTP Model Act and Agreement, as approved December 22, 2000, and amended January 24, 2001, allow states to become a party to the Agreement by executing an adopting resolution and by certifying compliance with the terms of the Agreement. Once five states have completed these steps, and each has gained the approval of three fourths of the other initial participating states, the Agreement becomes effective. Additional states petitioning for membership will be approved on a three fourths majority vote of member states, acknowledging the petitioning state's compliance with the Agreement. Similarly, expulsion of states for noncompliance and amendments and interpretations of the Agreement are subject to a three-fourths majority vote. The Agreement also contemplates a future governance structure by specifying that "member states must organize to govern compliance of each state participating the Agreement."

The NCSL Task Force, in its version of the Model Act and Agreement (as approved January 27, 2001), provides for an "interim governance" structure. Under this structure, all states that approve the Model Act will be entitled to participate in multistate discussions to review and amend the Agreement through July 1, 2003. Each state may appoint four representatives to the process, with each state having only one vote. After July 1, 2003, states in compliance with the Agreement will have the authority to amend it and will decide on procedures for its amendment. Until July 1, 2003, however, the Agreement may be amended by a single majority of the participating states.

As of July 2002, 15 states had adopted the NCSL version of the Model Act, 4 had adopted the SSTP Model Act and Agreement, 7 had adopted the SSTP Model Act, and 9 states had adopted a hybrid version (see Appendix).

Streamlined Sales Tax Implementing States

Based on the interim governance model in the NCSL version of the Model Act and Agreement, the states that had adopted either version of the Model Act or Agreement convened in an initial meeting in Salt Lake City on November 28-29, 2001. The group elected Tennessee State Representative Matthew Kisber and Utah Tax Commissioner Bruce Johnson to act as co-chairs. Under procedural rules set up by the SSTIS, votes to modify or amend the Agreement will require a simple majority for approval, except that final adoption of the Agreement will require an affirmative vote of three fifths of the implementing states. Each state is entitled to one vote. If a delegation from a state is undecided or equally split, however, that state will abstain.

Governance Questions

As of July 2002, further discussion of a governance model to administer the Agreement continues. Numerous questions over governance remain to be resolved. A preliminary list of the provisions being considered follows:

Entry provisions:

1. The Agreement shall become binding and take effect when at least 10 states comprising at least 20 percent of the total population of all states imposing a state sales tax have been found in substantial compliance with the requirements of the Agreement.
2. An initial state's membership shall be approved if it is found to be in compliance with the requirements of the Agreement by the other petitioning initial states.
3. An initial state shall not vote on its own membership.
4. Once at least 10 states with at least 20 percent of the total population of states imposing a state sales tax are mutually approved as member states, those initial states become the governing board of the Agreement.
5. Each petitioning state thereafter shall apply to the governing board.

Administration and compliance:

1. Each state shall certify and annually re-certify that it is in compliance with the requirements of the Agreement.
2. The certification and re-certification shall be signed by the chief executive of a state's tax agency.
3. If a state cannot re-certify its compliance with the Agreement, it shall file a statement of noncompliance. In its statement of noncompliance, the state shall list any action or decision that takes it out of compliance and the steps it will take to return to compliance.
4. Each state shall have one vote on the governing board.
5. The duties of the governing board shall consist of amending the Agreement, admitting new states, interpreting the Agreement, imposing sanctions or penalties, implementing and administering the dispute resolution process, and setting fees to carry out the administration of the Agreement.
6. All meetings of the governing board shall be open to the public except as specifically provided for personal issues, protection of confidential or proprietary information, and pending litigation.
7. A member state could be sanctioned y the governing board imposing voting restrictions, additional vendor compensation, or expulsion.
8. A Government Advisory Council and a Business and Taxpayer Advisory Council will provide input to the governing board.

Amendments to the Agreement:

1. The Agreement may be amended by three-fourths vote of the governing board.

Withdrawal from the system:

1. A state may withdraw from the Agreement on the first day of a calendar quarter with 60 days' notice. The withdrawing state shall continue to be liable for its share of any financial or contractual obligations that were incurred by the governing board prior to the state's notice of withdrawal.

HISTORICAL PERSPECTIVE ON THE SSTP: THE GREAT SALES TAX COLLECTION DEBATE

Background

Nearly every state that imposes a sales or similar transaction tax on the sale of tangible personal property and/or services imposes an identical compensating or use tax on the transaction if the sales tax does not apply. Because sales taxes are generally imposed on a destination basis, the use tax, as its name implies, is imposed on a transaction if the ultimate storage, use, or consumption of a product or service is in a taxing jurisdiction different from the jurisdiction of the sale. Sales and use taxes are meant to be complementary and are typically not imposed on the same transaction (at least by the same jurisdiction.) To collect such taxes, states impose a legal collection duty on sellers of goods or services that requires them to collect and remit sales and use taxes to the jurisdiction of sale or ultimate use. As remote sales (i.e., mail-order and catalog sales) grew in popularity in the late 1950s and early 1960s, the issue when a state could constitutionally impose such a collection duty grew as well.

National Bellas Hess v. Department of Revenue

In 1967, in *National Bellas Hess v. Department of Revenue*[106], the U.S. Supreme Court found that a state could not impose the duty of use tax collection and payment on a seller whose only connection with customers in the state was through a common carrier or the U.S. mail. National Bellas Hess, a mail-order house located in Kansas City, Missouri, was licensed to do business in Missouri and Delaware (its state of incorporation) and conducted its mail-order business by means of catalogs and occasional advertising flyers mailed to past and potential customers nationwide, including those in Illinois. Although the company maintained neither outlets nor sales representatives in Illinois, the Illinois Department of Revenue sought to impose a collection duty based on its statutory definition of retailer, which included any retailer engaging in soliciting orders within the state from users by means of catalogs or other advertising. National Bellas Hess argued that the liabilities imposed on the company violated the Due Process clause of the 14th Amendment and created an unconstitutional burden on the free flow of interstate commerce.

In its majority opinion, the Court, noting that the tests for determining violations of the Due Process clause and the Commerce clause were similar, held that the imposition of a collection duty on National Bellas Hess was unconstitutional, largely because of the burden imposed by the complexity of state sales tax systems. The Court found that many variations in rates of tax, in allowable exemptions, and in administrative and recordkeeping requirements could entangle the company's interstate business "in a virtual welter of complication obligations." The Court noted the sharp distinction in its prior cases between mail-order sellers with retail outlets, personnel, and property in a state and those doing no more than communicating with customers in a state by mail or common carrier. The strongly worded dissent, however, noted that such large-scale, systematic, continuous solicitation and exploitation of the Illinois consumer market was sufficient nexus to

[106] 386 US 753 (1967)

require National Bellas Hess to collect from Illinois customers and to remit the use tax.

In the 25 years following the Court's decision in *National Bellas Hess*, the mail-order and catalog industry grew exponentially. Because of the difficulty of effectively enforcing the use tax against individual consumers, the amount of uncollected use taxes grew as well. In the late 1980s, however, partly due to new Supreme Court Due Process and Commerce clause jurisprudence,[107] and partly due to the advent of computer software developed to assist in the administration and collection of use taxes on remote sales, state legislatures began enacting statutory language that closely mirrored the language in the *National Bellas Hess* dissent. Based on such statutes, and convinced that *National Bellas Hess* was anachronistic, departments of revenue in a number of states began issuing assessments against mail-order and catalog sellers engaged solely in the exploitation of a local market on a regular, continuous, and systematic basis. In 1992, in *Quill Corp. v. North Dakota,*[108] the issue reached the Supreme Court for a second time.

Quill Corp. v. North Dakota

Quill Corporation (Quill) was an out-of-state mail-order house with neither outlets nor sales representatives in North Dakota. It had offices and warehouses in Illinois, California, and Georgia, and its only contact with North Dakota was through delivery of products via U.S. mail or common carrier from out-of-state locations. North Dakota sought to force Quill to collect use taxes on Quill's sales into the state. The North Dakota Supreme Court had upheld the state's use tax assessment against Quill, based on a finding that the tremendous social, economic, commercial, and legal innovations since *National Bellas Hess* had rendered its holdings obsolete.

In *Quill*, the U.S. Supreme Court for the first time differentiated between the tests for determining whether a tax was constitutional under the Due Process clause or the Commerce clause. The Due Process clause, the Court noted, is concerned with fundamental fairness of governmental activity and is premised on whether a taxpayer has notice or fair warning that a tax may be imposed. The Commerce clause, on the other hand, is concerned with whether a given tax unduly interferes with the free flow of interstate commerce. Based on this distinction, the Court tiptoed through its prior precedents to find that the appropriate nexus standard under the Due Process clause was "minimum contacts" while the standard for passing Commerce clause muster was "substantial nexus." Further, the Court noted that a mail-order house such as Quill may indeed have the minimum contacts required for nexus under the Due Process clause, yet lack the substantial nexus with the state required by the Commerce clause.

Based on the distinction drawn in *National Bellas Hess* between mail-order sellers with outlets, personnel, or property in a state and those with contacts limited to delivery via U.S. mail or common carrier, the Court found that *National Bellas Hess* had established a physical presence requirement for imposing sales and use taxes under the Commerce clause. The Court noted that such a bright-line rule was justified because it firmly established the boundaries of legitimate state authority in the area

[107] See Complete Auto Transit, Inc. v. Brady, 430 US 274 Z (1977).

[108] 504 US 298 (1992).

and reduced litigation over sales and use taxes. Further, the Court found that the *National Bellas Hess* rule had engendered substantial reliance and had become part of the basic framework of a sizable industry. Accordingly, the Court reaffirmed that the bright-line test established in *National Bellas Hess* was still good law.

Perhaps the most significant aspect of the decision for purposes of this article is the fact that the Court noted that the underlying issue, collection of use taxes on remote sales, not only is an issue that Congress has the power to resolve but also is an issue that Congress may be better qualified to resolve. By separating the Due Process clause determination (where Congress has no power to act) from the Commerce clause standard, the Court effectively cleared the way for Congress to decide ; whether, when, and to what extent the states may burden interstate mail-order concerns with a duty to collect use taxes.

In the several years following *Quill*, numerous pieces of legislation seeking to overturn the decision and compel use tax collection were introduced in Congress, with little success. A significant effort to negotiate an agreement for mail-order sellers during this time was made by representatives of several states and the Direct Marketing Association. Although a tentative voluntary compromise was reached at the negotiating table, it failed through lack of sufficient participation by remote sellers. By the mid- to late 1990s, a new variable--electronic commerce via the Internet-had entered the debate and raised the ante, particularly for the states. Although the tax issues remained the same, the growth of the Internet and its ability to facilitate remote transactions took the debate (and the amount of forgone revenue) out of the distinct and quantifiable catalog and mail-order industry and into uncharted territory, both politically and economically.

The NTA Communications and Electronic Commerce Tax SSTP

In late 1996, the National Tax Association (NTA), in conjunction with the Federation of Tax Administrators, the Multistate Tax Commission, and the National Conference of State Legislatures, convened a meeting in Boston designed to bring together representatives of business, state and local governments, professional organizations, and academia to discuss the impact of changes in telecommunications law and technology and the development of the Internet on federal, state, and local tax systems. That meeting spawned the NTA Communications and Electronic Commerce Tax Project (the NTA Project), which quickly focused its debate on whether and how state and local taxes, particularly sales and use taxes, should be applied to electronic commerce.

The goal of the NT A Project was to develop a broadly available public report that identified and explored the issues involved in applying state and local taxes and fees to electronic commerce and that made recommendations to state and local tax officials regarding the application of such taxes. The NT A Project met nine times for the next two and one-half years and ultimately produced a final report nearly 100 pages long. Although the final report contained several recommendations that garnered varying degrees of consensus among participants, there were numerous issues on which participants could not reach agreement, including how and whether to expand the duty to collect use taxes to remote sellers, an adequate definition of1elecommunications, and how to avoid spillover to other taxes (such as business activity taxes) if the *Quill* sales and use tax nexus standard was changed. At the outset of the NTA Project participants agreed on a caveat underlying all work of the NTA Project: Nothing is agreed to until everything is agreed to. Consequently, the final report's

recommendations must be viewed through the prism of this caveat, that is, ultimately as part of a nonagreement. Despite the lack of agreement, the NT A Project served a valuable purpose. It forced participants to examine opposing viewpoints and explore complex tax issues at a previously unexplored depth. The knowledge and technical foundations gained thereby have been extremely helpful in the work of the SSTP.

The Internet Tax Freedom Act

As public acceptance and use of the Internet grew in the mid- to late 1990s, multiple state and local taxation of Internet access (e.g., America Online' s monthly charge) was one of the early justifications given for the enactment of the Internet Tax Freedom Act (ITFA). Several groups argued that, since the underlying telephone service was already taxed via state and local telecommunications taxes, Internet access delivered via telephone should be granted an exemption from sales tax. Further, because many consumers accessed the Internet from points throughout the country using a single Internet access account, it was difficult to determine which state or local government was entitled to tax the monthly access charge. Finally, state and local taxing authorities had strained the application of preexisting sales tax statutes to apply them to Internet access. Beginning October 1, 1998, and expiring October 31, 2001, the ITFA placed a three-year moratorium on multiple taxes, discriminatory taxes, and taxes on Internet access. Existing access taxes were grandfathered. In November 2001, President George W. Bush signed a two-year extension of the ITF A moratorium, through November
1, 2003.

Passage of the moratorium had little effect on existing state revenues. Under the legislation, a multiple tax is a tax imposed on electronic commerce that is also subject to tax in another jurisdiction without a credit mechanism. (Nearly all states grant such a credit, however, if the question of liability is resolved.) In addition, a discriminatory tax under the ITF A is a tax imposed on electronic commerce that is not imposed on other forms of commerce-a scheme that was present in very few state statutes at the time, if any. The ITFA's definition of discriminatory tax also includes a limitation on the ability of state and local taxing authorities to consider the maintenance of a Web site as the sole factor in determining a remote seller's tax collection obligation-also a rarity among
state nexus statutes.

Although the ITFA mainly preempted the states that sought to impose new taxes on Internet access, many in the media and the general public misconstrued the legislation as a blanket prohibition on all taxes imposed on sales over the Internet. Use taxes, imposed on a purchaser if the product was used in a location different from the location of the sale, are still due from customers on most retail transactions over the Internet, even if states are not in a position to enforce such taxes. Thus, the ITFA
was more about limiting new taxes on Internet access than it was about keeping the Internet tax free.

The Advisory Commission on Electronic Commerce

The lTFA added a significant factor to the sales tax collection debate-the creation of the Advisory Commission on Electronic Commerce (ACEC). To gamer the support of state and local government

leaders, the ITFA called for a commission to conduct an 18-month study of the impact of electronic commerce on all forms of taxation and called specifically for an examination of the issues surrounding the state and local taxation of transactions over the Internet. The ACEC was composed of 19 members, eight representing state and local governments, eight representing business and consumer groups, and the remaining three representing the offices of the U.S. Trade Representative, the U.S. Secretary of Commerce, and the U.S. Secretary of the Treasury. To ensure a balanced inquiry, a two-thirds supermajority was required to reach agreement on any finding or recommendation.

On April 3, 2000, 18 days before its expiration, the ACEC delivered its final report to Congress. After numerous conference calls and four in-person meetings held in Williamsburg, New York City, San Francisco, and Dallas, the ACEC was able to gain sufficient consensus to offer recommendations in only three areas: the digital divide, privacy implications of the Internet, and international trade and tariffs. The remainder of the majority report failed to achieve the two-thirds vote necessary for findings and recommendations contemplated by the ITFA.

Nevertheless, the report included a list of majority policy proposals, including the following:

1. Extend the ITFA moratorium on multiple and discriminatory taxes for five years, coupled with a five-year prohibition on sales taxation of digital goods and their tangible counterparts.
2. Enact a permanent moratorium on Internet access taxes.
3. Recommend the states simplify their sales and use and telecommunications tax systems.
4. Create bright-Line nexus standards for sales and use tax collection and business activity taxes.
5. Eliminate the 3 percent federal excise tax on telecommunications services.

The report also suggested that the states be given five years to simplify their transaction tax systems. This could lead to the extension of collection enforcement authority to remote sellers.

Because the suggestions included in the report did not receive the two-thirds majority called for in the statute, the report's release was not without controversy. The ACEC's majority, instead of allowing a single minority report, limited each individual commissioner (including those in the majority) to a separate personal statement of 1,000 words. The three federal representatives filed a consolidated personal statement that was scornful of the ACEC process. The federal representatives noted that the ACEC did not represent the full range of stakeholders, since no Main Street retailers had a seat on the ACEC and charged the chairman and other commissioners with changing the rules to allow submission of the majority report in contravention of the clear language of the statute. In sum, the three federal commissioners found the process fundamentally flawed.

The Rise of the SSTP

Rising from the detritus of the ACEC like a phoenix, the SSTP is the latest great hope of resolving the sales tax collection debate. The SSTP grew out of state enactment of model legislation-developed by the NCSL Task Force-authorizing state revenue department officials to work together in an ambitious effort to simplify state sales tax systems. The SSTP hopes to reduce the burden on interstate commerce through simplification to such an extent that it will encourage

voluntary collection and participation among remote sellers. Initially reluctant to embrace viewpoints other than those of sellers, the SSTP has since worked closely with all interested parties and has made great strides toward simplification. Although many of the more difficult issues are still left to contemplate, the SSTP's can-do approach toward reducing administrative burdens on businesses has encouraged many involved that a new paradigm is emerging and that true cooperation may finally lead to a workable resolution.

WHAT'S NEXT

The SSTP will continue its work on definitions and implementation of the administrative features of the Streamlined Sales Tax System in 2002. The SSTP will also assist the implementing states in developing the Agreement. The implementing states are expected to adopt the Agreement in the summer of 2002. Interested states will then pursue the legislation necessary to adopt the simplifications provided in the Agreement in 2002 and 2003 legislative sessions. The states that enact the provisions of the Agreement in 2002 and 2003 will be the governing states of the Streamlined Sales Tax System.

The SSTP intends to survey all participating states to identify exemptions that cannot be converted to user or entity exemptions under state law and intends to define the remaining universe of property and services. The goal is to develop a glossary of definitions from which a state can define its tax base.

APPENDIX
Enacted Legislation

SSTP Model Act and Agreement (4):

Minnesota
North Carolina
South Dakota
Wyoming

SSTP Model Act Only (7):

Arkansas
Kentucky
Maine
Nebraska
Rhode Island
Vermont
Wisconsin

NCSL Act (15):

District of Columbia
Florida
Illinois
Indiana
Maryland
Michigan
Missouri
Nevada
Ohio
Oklahoma
South Carolina
Tennessee
Texas
Washington
West Virginia

Hybrid (9):

Alabama
Arizona
Iowa
Kansas
Louisiana
New Jersey
North Dakota
Utah
Virginia

CHARGE 4

Review the effects of franchise tax credits authorized by S.B. 441, 76th Legislature, and evaluate their success in achieving legislative goals.

BACKGROUND

During the 76th Legislative Session, the Legislature passed a major tax exemption and credit bill, Senate Bill 441. S.B. 441, exempted some products from sales and taxes and made some business activities eligible for franchise tax credits.

Senate Bill 441 as originally introduced, primarily focused on addressing the regressive nature in the sales tax. The bill exempted medicine, diapers, medical or therapeutic appliances, devices, and any related supplies, and Internet access from sales taxes. As introduced S.B. 441 also exempted articles of cloth or footwear worn by a person younger than 13 years of age up to $500.[109]

By the time the bill was finally passed, it had been greatly expanded, particularly with regards to the matter of franchise tax credits.

Senate Bill 441 makes changes to the Tax Code relating to tax exemptions and credits. The act exempts from sales and use taxation blood glucose monitoring strips and certain over-the-counter drugs and medication, exempts Internet access service in an amount not to exceed the first $25 or a monthly charge, and exempts 20% of the value of data processing and information services. It establishes a three-day exemption for purchases of certain clothing and footwear, starting on the first Friday of each August. Beginning in 2000, a local taxing authority may repeal the local tax portion of the clothing and footwear exemption. The act establishes repeal and tax reinstatement procedure for this and any other sales and use tax exemption for which state law allows local repeal.

Franchise tax provisions expand the exemption for small corporations to include those whose gross receipts total less than $150,000. The Comptroller may require such a corporation to file an abbreviated information report but may not require it to report or compute its earned surplus or taxable capital.

New code subchapters provide franchise tax credits for research and development, job creation, qualified capital investments, contributions to school-age child care, and day care provision to a corporation's employees. The first three credits expire at the end of 2009, and the maximum credit for the three is 50% of the tax due. A corporation is eligible for the research and development credit or job creation credit, but not both, and similarly may receive only the capital investment credit or an enterprise zone franchise tax reduction. The research and development credit is doubled for research and development in a strategic investment area, defined to include counties with high unemployment and low per-capital income and certain federally designated communities. The job creation credit applies to activity locations, including strategic investment areas, by qualified businesses, in specific

[109] Senate Bill 441, Introduced Version, Bill Analysis, 76th Legislature, Senate Research Center.

industries, that meet wage, group health benefit, and other criteria. Corporations that transfer jobs only intrastate do not qualify. The capital investment credit applies to certain investments of $500,000 or more by corporations meeting wage, group health benefit, and other criteria.

New reporting and informational requirements are imposed on the Comptroller relating to exemptions and credits contained in the act.

Clothing and footwear provisions take effect June 3, 1999. Franchise tax provisions, except for those related to the Comptroller's report on the small corporation exemption expansion, take effect January 1, 2000. The exemptions on glucose strips and over-the-counter drugs and medications take effect April 1, 2000. The remainder of the act takes effect October 1, 1999.[110]

Now because all of the tax credits are earned in one year and received in the next, and because franchise tax collections are done on a calendar year, the information available on credits received is only current up until those reported for 2001. The 2003 credits, earned during 2002, have not yet been calculated. For example, companies spending money to earn credits in 2002, will not apply for them until somewhere around January 2003.

2001 Franchise Tax Reports

Credit	Number of Firms	Credit Earned	Credit Applied
Research and Development	202	$69,505,844	$8,759,859
Investment	53	$26,636,408	$7,792,702
Job Creation	20	$1,410,174	$1,125,607
Child Care	14	$1,387,823	$224,407
After-School Care	3	$1,854	$1,854

Due to the statutory limits on how much credit a company can take in a single year, any difference between the amounts earned and the amounts applied is typically carried forward to future tax years.

The Comptroller has determined from these numbers that the franchise tax credit will not produce any significant shifts in the Texas economy. This is primarily due to recent slow economic growth. For example, the franchise tax credits main purpose was for investment and job creation, and in that program's first year of implementation only 13% of the projected savings were attained. The job creation program in particular resulted in only 900 jobs during the year, compared to 900 a week

[110] Summary of Enactments, 76th Legislature, Regular Session 1999, Texas Legislative Council, September 1999.

during a prosperous economy.[111]

RECOMMENDATION

The Ways and Means Committee recommends the 78th Texas Legislature:

- Continue to monitor the tax exemptions and credits granted under S.B. 441.
  The current economic climate is not one in which to properly assess the impact if any these exemptions and credits may have.

[111] Testimony of James LaBas, Chief Revenue Estimator, Texas Comptroller of Public Accounts, Ways and Means Committee Hearing, April 24, 2002.