

Schools and Taxes: A Summary of Legislation of the 2006 Special Session

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In November 2005, the Texas Supreme Court upheld a ruling by state District Judge John Dietz of Austin that school districts lacked “meaningful discretion” in setting local maintenance and operation (M&O) tax rates, effectively resulting in an unconstitutional state property tax. The court ordered the Legislature to remedy the constitutional infirmity in the school tax system by June 1, 2006, or else the court would enjoin the state from distributing funding for the public school system.

Gov. Rick Perry called the Legislature into special session on April 17, 2006, to address the Supreme Court’s decision. He asked the Legislature to reduce school property tax rates and to consider new sources of state revenue dedicated to replacing local revenue from the school property tax reduction.

In November 2005, the governor appointed the Texas Tax Reform Commission, chaired by former Comptroller John Sharp, to devise a new business taxation system to replace the corporate franchise tax. The commission proposed a new business tax based on the “margin” between gross receipts and either personnel costs or the cost of goods sold, with all corporations and limited liability partnerships subject to the tax, subject to certain limitations and exemptions depending on the type of business and its business volume. The commission also proposed establishing a standard presumptive value of motor vehicles for determining sales taxes and an increase in the tax on cigarettes and other tobacco products. The commission recommended that the additional revenue from these new taxes, plus general revenue from the state budget surplus, be dedicated to reducing school M&O property taxes by at least one third.

In its third called session (April 16-May 15, 2006), the 79th Legislature essentially adopted the commission's recommendations, enacting a revised business franchise tax (HB 3 by J. Keffer), a motor vehicle standard presumptive value for sales tax purposes (HB 4 by Swinford), and an increase in the tax rate for cigarettes and other tobacco products (HB 5 by Hamric), with all of the additional revenue generated by these new or revised taxes dedicated to reducing school property tax rates (HB 2 by Pitts). According to Legislative Budget Board (LBB) estimates, the new taxes will not generate enough revenue to cover the full cost of reducing school property taxes mandated in HB 1 by Chisum, requiring an additional spending commitment to make up the difference.

In HB 1, the Legislature mandated a one-third reduction in school district M&O taxes by tax year 2007. For districts now taxing at the maximum of \$1.50 per \$100 valuation, the base tax rate will drop by 11.3 percent, to \$1.33 in the 2006 tax year, and by one third, to \$1.00 in the 2007 tax year. School districts would have the discretion to levy up to 4 cents per \$100 beyond the base tax rate in "enrichment" taxes without voter approval. Additional enrichment taxes would have to be approved by district voters in an election.

Property-wealthy districts will not have to return revenue raised by the first 4 cents (the first 6 cents, starting in 2009) of their enrichment tax under the "Robin Hood" recapture system, and other districts will receive additional state aid to equalize the yield from their enrichment tax. State aid to equalize the yield from all M&O taxes also will increase.

Teachers, librarians, counselors, and nurses will receive a \$2,000 per year pay increase, and their \$500 health insurance supplement will be converted to salary. New performance pay incentive programs will reward teachers and other educators for improved student performance and for teaching at high-performing schools with disadvantaged students. A new allotment of \$275 per student in grades 9-12 will be used to reduce dropout rates, prepare students for college, and increase state support for high school programs. High school students will have to take four years of math and science to graduate. The school year in all districts must begin on the fourth Monday in August. More school district financial information must be made accessible to the public.

This report summarizes the legislation enacted during the 79th Legislature's third called session.

HB 1 – School Property Tax Reduction and Public Education Revisions

HB 1 by Chisum provides state aid to school districts to reduce maintenance and operation (M&O) property taxes by 11.3 percent in tax year 2006 and one third (33.3 percent) in tax year 2007 and beyond. For districts taxing at the current \$1.50 M&O cap, the M&O rate will be \$1.33 per \$100 valuation in tax year 2006 and \$1.00 per \$100 in tax year 2007. The state may provide additional funding for further property tax relief in the future based on the availability of revenues from the new state taxes enacted during the special session and legislative appropriations.

The bill allows school districts to raise additional revenue beyond the compressed M&O tax rate by adding “enrichment” taxes. Districts generally can raise their enrichment tax by 4 cents per \$100 valuation, with voter approval in an election required for tax rates above that level. The current \$1.50 per \$100 cap on school M&O property tax rates is repealed and replaced with a new cap of \$1.17 beginning with tax year 2007, with the cap lowered proportionately if the state further reduces school property taxes.

Local enrichment funds up to 4 cents (6 cents starting in 2009) will be “equalized” with state aid to ensure that each district, at the same tax effort, can raise the same amount as the Austin Independent School District (currently about \$41.22 per penny per student). These enrichment funds also will not be subject to “recapture” – the process by which the state redistributes local property tax revenues from property-wealthy districts so that students in less wealthy districts receive roughly equal funding. Additional enrichment pennies beyond 4 cents (6 cents in 2009) will be subject to recapture and the same level of equalization as other M&O revenue.

In 2007, HB 1 increases from \$27.14 to \$31.95 the amount per student per penny that each district, regardless of property wealth, is guaranteed to raise at the same level of tax effort. (This “guaranteed yield” accounts for the extra costs involved in educating certain students, including those in bilingual and special education programs.) In addition to increasing the basic level of funding per weighted student from \$2,537 to \$2,748, the bill provides to districts \$275 per student in grades 9-12 for dropout prevention and college readiness programs, with the same amount per student going to districts regardless of property wealth or special needs.

School districts and charter schools will receive state funding to provide \$2,000 annual pay raises for teachers and full-time nurses, counselors, and librarians. The health insurance supplement that employees formerly received – \$500 for full-time staff and \$250 for part-time staff – is converted to salary. In addition, HB 1 creates an “Educator Excellence Fund” that, beginning September 1, 2008, will provide up to \$100 million in annual incentive payments to classroom teachers who effectively improve student achievement. A second program provides up to \$100 million in state funds for the 2006-07 school year to reward teachers who improve student achievement in schools with a high percentage of educationally disadvantaged students.

HB 1 establishes new accreditation standards for school districts and creates new sanctions for low-performing campuses and charter schools. Possible sanctions include interventions by expert teams, changes in school staff and management and, ultimately, the closure of failing schools.

Among its numerous other changes, HB 1:

- requires schools to start the fourth Monday in August unless the district operates a year-round system;
- requires high school students to complete four years of math and science, beginning with students entering 9th grade in the 2007-08 school year;
- requires districts to hold school board elections on the same dates as city-wide or general elections;
- halts the issuance of future textbook proclamations so that the Legislature can consider reforms to the system of procuring and purchasing textbooks; and
- requires school districts to make summaries of proposed annual budgets available on the Web.

School district taxes and school finance

HB 1 provides state funding for school districts to reduce property taxes for M&O based on a “state compression percentage.” Districts will have to reduce their tax year 2005 M&O taxes by 11.3 percent for tax year 2006 and 33.3 percent for tax year 2007, with a higher percentage reduction in future years if the new taxes enacted during the special session raise additional revenue or the Legislature

provides additional funding. In 2006, districts will be able to impose up to 4 cents in additional M&O “enrichment” taxes beyond the compressed rate, but enrichment taxes at a higher rate will require voter approval in an election. Similar limits will apply to future enrichment tax increases. The current statutory \$1.50 cap on M&O taxes is repealed, with the new cap being the state M&O tax reduction percentage times \$1.50, which in tax year 2007 would be \$1.00, plus 17 cents, for a total of \$1.17.

The revenue generated by the first 4 cents of enrichment taxes (the first 6 cents starting in 2009) will be “equalized” with state funds to ensure that every district has access to the same level of property wealth as the Austin Independent School District and will not be subject to recapture. Any additional enrichment tax revenue will be subject to recapture and equalized to ensure that districts have access to the same revenue as a district in the 88th percentile of school district property wealth in the state, as will revenue generated by M&O taxes below the enrichment rate.

Tax reduction. HB 1 provides state aid to school districts to reduce local property taxes. Districts will calculate their reduced M&O tax rates according to a “state compression percentage” of 88.67 percent of their 2005 tax rate in fiscal 2007 and 66.67 percent of the 2005 tax rate in fiscal 2008. For a district taxing at \$1.50 per \$100 of valuation in 2005, the compressed rate will be \$1.33 in the 2006 tax year and \$1.00 in 2007. Beginning in fiscal 2009, the Texas Education Agency (TEA) will determine the state compression percentage based on appropriations from the property tax relief fund established by HB 2 by Pitts or other funding for this purpose.

Subject to constitutional authorization, HB 1 also would reduce proportionately the school taxes owed by individuals whose property tax bills are frozen because they are disabled or reached 65 years of age. HJR 26 by Berman, which would have proposed a constitutional amendment authorizing a reduction in the tax freeze amount proportionate to the reduction in school M&O taxes, passed the House but died in the Senate during the third called session.

To offset the school tax reduction, districts will receive \$2,500 in “hold harmless” funding for each classroom teacher and full-time nurse, librarian, and counselor, \$275 for each student in average daily attendance (ADA) for grades 9-12, and the greatest of:

- the amount of state and local revenue per “weighted” student in average daily attendance (WADA) available to the district for the 2005-06 school year;
- the amount of state and local revenue per weighted student to which the district would have been entitled under current law, using 2005-06 funding formulas, based on the district’s 2005 M&O tax rate; or
- the amount of state and local revenue per weighted student to which the district would have been entitled under current law, using 2005-06 funding formulas, based on the district’s 2006 rollback tax rate.

The bill also includes “hold harmless” provisions for the Texas School for the Blind and Visually Impaired, the Texas School for the Deaf, juvenile justice alternative education programs, and groups of school districts formed to provide technology services to member districts.

State tax reduction funds may not be used to fund facilities or provided to school districts for a purpose other than reduction of the district’s M&O rate. HB 1 also specifies that TEA may not consider state funds appropriated to school districts for property tax reduction to be excess funds as part of adjustments the agency makes in its payments to school districts for the cost of education or rapid decline in local property values.

The LBB estimates that the cost of replacing local tax revenue with state funds will be about \$2.1 billion in fiscal 2007 and approximately \$13.5 billion in fiscal 2008-09. In total, the state’s share of funding for public education is expected to rise from less than 40 percent to approximately 50 percent.

Equalization. Under current law, school district M&O funding is divided into two tiers. Tier 1 ensures a basic level of funding of \$2,537 for each student in ADA for the first 86 cents of local tax effort, with adjustments made for various student and district characteristics. Tier 2 guarantees districts that they will earn a “guaranteed yield” of \$27.14 per WADA per penny of local tax effort between 87 cents and \$1.50. (Districts receive additional funding per student based on specific “weights” that account for factors such as bilingual or special education costs.) If a district’s local tax effort does not generate \$27.14 per WADA, state funds make up the difference.

HB 1 increases state funding formulas by basing them on the amount of tax revenue available to a district with property tax wealth per WADA in the 88th percentile of all school districts in the state. For fiscal 2007, the basic allotment will increase from \$2,537 under current law to \$2,748 per WADA, the “guaranteed yield” will increase from \$27.14 to \$31.95, and the “equalized wealth level” will rise from \$305,000 to \$319,500.

Enrichment tier. HB 1 establishes a third “enrichment” tier for M&O that allows school districts additional local property tax revenue beyond the compressed tax rates. Generally, school districts will be able to increase local school property taxes by up to 4 cents per \$100 of valuation above the new compressed rates without voter approval. Any additional local school property tax increase will require the approval of a majority of voters in an election.

Rollback rate for voter approval. Besides setting its actual M&O tax rate, a school district also must calculate its effective tax rate, which generally is the rate that would raise the same amount of money using the current year’s taxable property wealth base as the past year’s actual tax rate generated using the past year’s property wealth base. For example, if the value of the district’s property wealth base increased, then its effective tax rate would be lower than its actual tax rate.

If a school district adopts a tax rate that exceeds the district’s “rollback” rate, voters must approve the new rate by majority vote in an election. Under previous law, the “rollback rate” generally was a district’s effective M&O tax rate, plus 6 cents, plus the tax rate required to pay for any district debt.

Under HB 1, the rollback rate – the rate beyond which districts must obtain voter approval – for the 2006 tax year will be the sum of the rate that is 88.67 percent of the district’s 2005 M&O tax rate, plus 4 cents, plus the district’s current debt rate. If required, a rollback election to approve the district’s adopted tax rate for the 2006 tax year must be ordered by August 31, 2006, and held on September 30, 2006.

For 2007 and subsequent tax years, the rollback rate will be the lesser of:

- the state compression percentage times \$1.50, plus 4 cents, plus the difference between the tax rate adopted by an election in 2006 and each subsequent tax year minus the rollback rate, plus the district’s current debt rate; or
- the effective M&O tax rate, the state compression percentage times 6 cents (which at the 2007 percentage would be 4 cents), plus the district’s current debt rate.

Using an example issued by the Governor’s Office, a school district taxing at the \$1.50 per \$100 M&O cap in tax year 2005 will have its M&O rate reduced by 11.33 percent for tax year 2006, to a base rate of \$1.33. If the district decides for tax year 2006 to levy an enrichment tax of an additional 4 cents (the maximum allowed without voter approval in an election), the district’s 2006 M&O rate will total \$1.37. For tax year 2007, the district’s original \$1.50 M&O tax will be reduced one-third, to a new base rate of \$1.00. With the extra 4 cents enrichment tax added the previous year, the 2007 M&O tax will be \$1.04.

Under this example, for the district to determine if it could increase its enrichment tax in 2007 without an election, it would calculate the rollback rate in two different ways, with the lower rate applying. The state compression percentage (66.67 percent) times \$1.50 is \$1.00, plus 4 cents, equals \$1.04. If the district’s property value base increased from the previous year, the effective M&O tax rate would be a lower rate that would raise the same amount of revenue on a higher value tax base. If that rate were 99 cents, then it would be added to the product of the state compression percentage – (66.67 percent) times 6 cents, which is 4 cents – for a total of \$1.03, which would be the lower rate. If the district wanted to increase its M&O tax rate beyond \$1.03 by adding an enrichment tax, it would have to gain voter approval in an election.

HB 1 also repeals the \$1.50 cap on M&O tax rates in current law but specifies that M&O tax rates may not exceed the sum of 17 cents and the product of the state compression percentage times \$1.50. For districts now taxing at \$1.50 per \$100 of valuation, this would establish a new M&O tax cap of \$1.17 beginning with the 2007 tax year – the compressed rate of \$1.00, plus 17 cents. Since the cap is based on the state compression percentage, it would be lowered proportionately if the state further reduced school property taxes. Districts not currently taxing at the \$1.50 M&O tax cap would have more leeway to levy enrichment taxes up to the new cap.

The general purpose of the formulas and calculations in HB 1 is to use state funds to replace a portion of school M&O property tax revenue and reduce base M&O taxes, give school districts the meaningful discretion required by the Supreme Court to set their own tax rates by allowing them to add another 4 cents in enrichment M&O taxes beyond the compressed base rate, and require voter approval for enrichment taxes beyond the 4 cents, but with a cap on enrichment taxes of 17 cents or more depending on a district's 2005 M&O rate.

The rollback rate reduction and enrichment cap calculations also would apply to a few Harris County districts now allowed by law to exceed the \$1.50 M&O cap by substituting their 2005 M&O tax rate for \$1.50.

Equalization and recapture of enrichment tax revenue. The first 4 cents of revenue (the first 6 cents starting in 2009) generated by school district M&O enrichment taxes will be “equalized” to ensure that every school district can access enrichment funding at the same level as the Austin Independent School District (currently approximately \$41.22 per penny per WADA). If a district's local tax effort does not generate this level of income, state funds will be used to make up the difference. For fiscal 2007, LBB estimates that the cost to the state of equalization in the enrichment tier will be about \$478 million.

Under the current “recapture” system, school districts are prohibited from having property tax wealth per student of more than \$305,000. Districts with property tax income above this “equalized wealth level” must give up the additional revenue. Most districts do so by either purchasing attendance credits from the state or entering into contracts with low-wealth school districts. Since they are in the upper percentiles of district wealth statewide, “recapture” districts do not receive equalization funding.

The first 4 cents of local enrichment revenue (the first 6 cents starting in 2009) will not be subject to recapture, provided that the state provides equalization funding for districts not subject to recapture at the level of wealth for the Austin Independent School District. If the level of state equalization falls, recapture would increase accordingly.

Enrichment pennies after the first 4 cents (the first 6 cents starting in 2009) will be subject to the same equalization funding formula levels in Tier 2, with the

guaranteed yield of \$31.95 (based on the 88th percentile of wealth in fiscal 2007) and an “equalized wealth level” (above which districts are subject to recapture) at \$319,500.

High school allotment. The funding formulas for distributing state aid to school districts include special “allotments” for certain types of students, such as those identified as gifted and talented or students who qualify for bilingual education. HB 1 provides school districts with \$275 for each student in grades 9-12 in ADA. Districts must use this “high school allotment” for dropout prevention and college readiness programs. TEA will have to develop standards for evaluating the success and cost effectiveness of high school completion and success programs and provide guidance to districts for improving these programs.

Districts also may use the high school allotment to meet the bill's new requirement of four years of high school science and mathematics. The allotment can be used for any instructional program for grades 6-12 if a district meets a new indicator of “exceptional” and meets or exceeds high school completion rate requirements under the state's academic accountability system.

Spending shift repeal. To produce a one-time general revenue spending reduction in the fiscal 2004-05 budget, the Legislature delayed the last payment for the school year to school districts, which had been scheduled for August 25, into the following fiscal biennium, which begins on September 1. Beginning in 2009, the final Foundation School Program (FSP) payment to school districts, which currently is distributed between September 5 and 10, will have to be made on or before August 25. According to the LBB, moving the final FSP payment into the 2009 fiscal year and restoring the previous payment schedule will incur a one-time state cost of \$800 million in fiscal 2009.

Educator pay and training

Teacher pay raise. School districts and charter schools will receive state funding to provide \$2,000 annual pay raises for each employee subject to the state minimum salary schedule (teachers and full-time nurses, counselors, and librarians). The \$2,000 will be in addition to wages the district might otherwise pay the employee during the school year.

In 2001, as part of a state-administered health insurance program for teachers and other public school employees, the 77th Legislature created a health insurance supplement or “passthrough” of \$1,000 per employee per year that could be used to purchase additional coverage, pay premiums for dependent coverage, deposit into a health care reimbursement account, or be taken as cash. In 2003, the 78th Legislature reduced the amount of the supplement to \$500 for full-time employees and \$250 for part-time employees and eliminated it entirely for administrators.

HB 1 eliminates the health insurance supplement, or passthrough, and converts it to salary by providing salary increases of \$500 for full-time employees (excluding administrators) and \$250 for part-time employees. Employees also may elect to have up to \$1,000 per month in pre-tax salary withheld for health insurance and other allowable expenses.

Incentive programs. HB 1 establishes two new state grant programs to provide incentive payments for classroom teachers and other school employees. School districts will have to include in employee contracts the condition that any incentive payment distributed will be considered a payment for performance, such as a bonus, and not an entitlement as part of an employee’s salary. However, the income would be considered salary for retirement and benefit purposes under the Teacher Retirement System.

TEA or an outside contractor will conduct a comprehensive evaluation of both state educator incentive programs. The evaluation must include descriptions of awards granted to campuses, detailed information regarding the distribution of incentive awards to classroom teachers, and a comprehensive and quantitative analysis of the impact of the awards programs. By December 1, 2008, TEA must deliver a report to the Legislature describing the interim results of this evaluation.

Rewards for improved student performance.

An “Educator Excellence Fund” in the state’s general revenue fund will be used to finance award incentive payments to classroom teachers. The program will be funded through annual deposits into the fund by TEA of \$840 for each classroom teacher in the state in 2007 and \$1,000 per classroom teacher in 2008 and beyond. Each fiscal year, beginning September 1, 2008, TEA must use up to \$100 million to provide grant awards to school districts

to reward teachers for student achievement. Any remaining funds can be divided among qualified districts based on average daily attendance.

For this grant program, a district-level committee must design local incentive plans that meet minimum criteria and are approved by TEA. The plans may include all campuses in a district or only certain campuses selected by the district-level committee. A majority of classroom teachers on a selected campus must approve participation in the program.

A school district that receives an incentive award must use at least 60 percent of grant funds to directly reward classroom teachers who effectively improve student achievement as determined by meaningful, objective measures. The remaining funds can be used only to provide stipends for certain purposes, such as mentoring or teaching in a shortage area, providing awards for principals and other employees, or implementing the components of a Teacher Advancement Program, which is designed to attract and retain teachers in the profession.

Rewards for teachers at high-performing campuses with disadvantaged students. A second grant program provides up to \$100 million in state funds for the 2006-07 school year for a program to reward teachers who demonstrate a positive impact on student achievement in schools with a high percentage of educationally disadvantaged students. To qualify for an award under this program, a campus must be ranked exemplary or recognized under the state accountability system or ranked in the top quartile of campuses in comparable improvement in math and reading. School districts will submit grant proposals developed by a campus-level committee on behalf of an eligible campus but must demonstrate the involvement of classroom teachers in the development of the proposal. Grant proposals also must demonstrate evidence that the campus plan has been made available to the public.

A campus that receives a grant under this program must use 75 percent of its award to provide incentive payments of between \$3,000 and \$10,000 for each classroom teacher who qualifies for an award. Incentive payments may be distributed only to teachers who demonstrate success in improving student achievement using objective, quantifiable measures – e.g., local benchmarking systems, portfolio assessments, end-of-course assessments, and value-added assessments – and who successfully collaborate with other faculty and staff members in a manner that contributes to

improving overall student achievement. Campuses also can consider whether a teacher is assigned to a shortage area or demonstrates initiative, commitment, professionalism, and involvement in an activity that directly results in improved student achievement.

The other 25 percent of the campus award can be used for other specific purposes, including incentive payments to other campus employees who have contributed to student achievement, professional development for classroom teachers who did not receive an incentive award, signing bonuses for new teachers, and activities that support teacher improvement. Incentive awards may not be issued to employees whose primary responsibility is supervision of an athletic activity.

Mentor program. School districts may assign experienced teachers to mentor colleagues who have fewer than two years of experience and, ideally, teach the same subject or grade level at the same school as the mentor. TEA may provide funds for this program and must adopt rules for its administration, including rules governing the duties and qualifications of teachers.

School leadership pilot program for principals. TEA will establish a school leadership pilot program for principals in cooperation with a nonprofit corporation that has substantial experience in developing best practices to improve leadership skills, student achievement, student graduation rates, and teacher retention. Principals of campuses rated academically unacceptable will be required to participate in the program.

TEA can use up to \$3.6 million in funds appropriated to the agency in fiscal 2007 to finance the program. During the first semester of the 2008-09 school year, TEA will evaluate the effectiveness of the program and, by January 1, 2009, report the results to the Legislature.

Financial transparency

School district budgets. Along with a notice of a public meeting to discuss and adopt a budget, school districts must post a summary of the proposed budget on the district's Web site or in its central administrative office. The budget summary must include information on per student and aggregate spending on instruction, instructional support, central administration, district operations, debt service, and

any other category designated by the commissioner. The summary also must include a comparison to the previous year's budget.

TEA annually must establish and publish proposed expenditure targets for each school district, including expenditures for instruction, central administration, and district operations. If the school board intends to exceed this target, it must publish and adopt a resolution that includes an explanation justifying its actions.

TEA must contract with a qualified third-party to conduct a comprehensive review of school district accounting systems and provide recommendations for improvements in the transparency of district spending behavior, more thorough information relating to campus spending, and facility program evaluations. TEA must submit the results of this review to the Legislature by January 1, 2007. TEA also must submit a report to the Legislature by January 1, 2007, evaluating the benefits of providing school districts with standardized accounting software.

The state's financial accountability system must distinguish among school districts based on levels of financial performance and include additional procedures to provide transparency to public school finance and enable the commissioner and school district to provide meaningful financial oversight and improvement.

Internal auditors hired by school districts must be hired directly by and report directly to the school board.

Public access to PEIMS data. TEA must develop a request for proposal for a third party contractor to develop and implement procedures to make available, through the TEA Web site, all financial and academic performance data submitted through the Public Education Information Management System (PEIMS) for school districts and campuses. This information must be easily accessible to the public and must provide the ability to view and download state, district and campus-level information. An advisory panel made up of educators, interested stakeholders, business leaders and other interested members of the public will provide input on developing a system that is easily accessible by the general public and contains information of primary relevance to the public. By August 1, 2007, TEA must implement procedures for making financial and academic performance information for school districts and campuses available through the agency Web site.

Shared service agreements among districts.

By December 1, 2006, TEA must evaluate the feasibility of including in its financial accountability rating system an indicator that measures effective administrative management through the use of cooperative shared service agreements. It must include the indicator in the rating system if determined to be feasible. Each regional education service center must notify each school district it serves regarding opportunities for shared service agreements and evaluate the need for these agreements. Each service center will assist school boards in entering into agreements with other school districts, governmental entities, or higher education institutions to provide administrative services, including transportation, food service, purchasing, and payroll functions. Under certain circumstances, TEA can require a school district or charter school to enter into a shared service agreement for administrative services.

Accountability

Accreditation system for school districts. HB 1 establishes new accreditation standards for school districts that take into account a district's fiscal as well as academic performance. TEA will establish procedures and adopt rules for assigning districts an annual accreditation status of accredited, accredited-warned, or accredited-probation. In determining a district's accreditation status, TEA must take into account the district's performance under the state's academic and financial accountability system. The agency also may consider the district's compliance with TEA and State Board of Education (SBOE) rules relating to data reporting through PEIMS, high school graduation requirements, school district waivers, the effectiveness of the district's programs for special populations, and the effectiveness of the district's career and technology programs.

If a school district's accreditation status is "accredited-warned" or "accredited-probation" for two consecutive years, including the current school year, if the district has been rated academically unacceptable under the state accountability system, or if the district has failed to satisfy TEA financial accountability standards, TEA can revoke the district's accreditation and order it closed.

TEA must notify school districts that received a status other than "accredited" that the district's performance was below TEA standards. The district must notify parents and property owners of its accreditation status and the

implications of this status. A school district that is not accredited may not receive state funds or hold itself out as a public school district.

TEA must adopt rules to provide a process for a school district or charter school to challenge a TEA decision regarding an academic or financial accountability rating that affects the district or school. Under these rules, the commissioner must appoint a committee to make recommendations to TEA on a challenge of an academic or financial accountability rating. Agency employees may not serve on the committee. The commissioner can limit a challenge to a written submission of any issue identified by the district or school challenging the agency decision. After considering the recommendation of the committee, TEA must make a final decision, which cannot be appealed.

Sanctions for low-performing campuses. The following sanctions will apply to public and charter school campuses. TEA will adopt rules requiring that a charter be automatically revoked if a low-performing charter school is ordered closed or modified if an individual campus is ordered closed.

Technical assistance. If a campus rated academically acceptable for the current school year would be rated unacceptable at the same level of academic performance under the following year's standards, TEA must select and assign a technical assistance team to help the campus develop a school improvement plan and any other strategies TEA considers appropriate.

Campus intervention teams. If a campus is identified as academically unacceptable, TEA must assign a campus intervention team. A campus intervention team must conduct a comprehensive on-site evaluation of the campus, recommend actions for improvement, assist in the development of a school-improvement plan, and assist TEA in monitoring the campus's progress in implementing the school improvement plan.

In conducting a comprehensive needs assessment, the campus intervention team must follow guidelines and procedures to assess such areas as staff certification and training, compliance with class-size rules, quality of materials, parental involvement, the extent and quality of mentoring programs and professional development for staff, disciplinary incidents and school safety, financial and accounting practices, appropriateness of curriculum and

teaching strategies, and any other research-based data. On the basis of this information, the campus intervention team must recommend specific actions.

TEA may determine when the services of a technical assistance or campus intervention team no longer are necessary.

Reconstitution of low-performing campuses. If a campus has been identified as academically unacceptable for two consecutive years, including the current school year, TEA may order the reconstitution of the campus and assign a campus intervention team to assist in developing a school improvement plan. TEA must approve the plan and its execution. The campus intervention team must decide which educators may be retained at that campus. A principal who has been at the campus during the full two-year period in which the campus was rated academically unacceptable cannot be retained at that campus. Teachers of subjects on the TAKS test may be retained only if the campus intervention team determines that students of a particular teacher have shown significant academic improvement.

Alternative management or closure of campus. If TEA determines that a campus subject to reconstitution is not fully implementing the school improvement plan or if a campus is considered academically unacceptable one year after reconstitution, TEA can pursue alternative management of the campus or order its closure. If a campus continues to be considered academically unacceptable for two years after its reconstitution, TEA must order the campus closed or pursue alternative management.

If TEA has ordered alternative management of a campus, the agency must solicit proposals from qualified nonprofit entities to assume management of the campus or may appoint a school district other than the one in which the campus is located but that is within the boundaries of the same regional education service center to assume management of the campus.

If TEA determines that the low rating stemmed from a specific condition that might be remedied with targeted technical assistance, the proposal process could be postponed for one year, and the district must contract for the appropriate technical assistance.

To qualify for consideration as a managing entity, the entity must submit a proposal containing information relating to the entity's management and leadership team that will participate in the management of the campus. TEA must select a management entity that meets standards specified in the bill and has had demonstrated success in educating students from similar demographic groups with similar educational needs as the campus to be operated by the management entity. The school district can negotiate the term of the management contract for not more than five years, with an option to renew. The contract must delineate the district's responsibilities in supporting the operation of the contract. It also must include provisions demonstrating improvement in campus performance, including negotiated performance measures. TEA must conduct a performance evaluation in each of the first two years, and the district may terminate the contract and solicit new proposals if the evaluations fail to show improvement as negotiated under the contract.

Funding for a campus operated by a management entity would be equivalent to per-student funding for other campuses in the district. Each campus would be subject to the same regulations governing other schools in the district.

School districts or charter schools that wish to challenge a decision to turn over to alternative management or close a district, district campus, or charter school must do so through the State Office of Administrative Hearings (SOAH). The decision of the SOAH administrative law judge is final and cannot be appealed.

Academic measurement system. Beginning with the 2007-08 school year, TEA will adopt a method for measuring the change in a student's performance from one year to the next on required assessments, such as the TAKS test. Using each student's previous year's performance data, TEA will determine the student's expected and actual levels of annual improvement. TEA also will determine and report each year to the district the annual improvement required for a student to be prepared to pass the exit-level TAKS.

Each year, TEA will provide each student's school district with a report of whether the student fell below, met, or exceeded improvement targets. School districts must provide this information to the student's teachers that taught each of the subjects on the TAKS test and provide a written notice to the student's parents.

College readiness

Fourth year of high school science and math. Under current law, in order to graduate, students entering high school in the 2005-06 school year or later must complete the recommended or advanced high school curriculum, which includes four years of English, three and one-half years of social studies, one semester of economics, and three years of science and math.

HB 1 directs the SBOE to adopt rules requiring that high school students complete four years of English, math, science and social studies as part of the recommended and advanced high school curriculum. One or more courses must include a research writing component. The rules must be adopted by January 1, 2007, and must require the new standards to apply to students entering the 9th grade beginning with the 2007-08 school year.

End-of-course assessments. To the extent practicable, TEA must ensure that any high school end-of-course assessment it produces be developed in such a manner that it may be used to determine the appropriate placement of a student in a course of the same subject matter at an institution of higher education.

P-16 college readiness strategic plan. HB 1 requires the P-16 Council, which is responsible for creating stronger links between preschool, public education, and higher education programs, to develop a college readiness and success strategic action plan. The goal of the plan is to increase student success and decrease the number of students enrolling in developmental course work at higher education institutions.

The plan will have to include standards and expectations for college readiness, describe the components of an individualized graduation plan sufficient for college success, describe how TEA will provide model curricula for use as a reference tool by school district employees, and include recommendations for improvement in teacher training to prepare students for higher education. By December 1 of each odd-numbered year, TEA and the Texas Higher Education Coordinating Board (THECB) will submit a report to the governor, the lieutenant governor, the speaker of the House, members of the LBB, and members of the Senate and House education committees describing progress in implementing the strategic plan.

Programs to enhance student success. To implement the P-16 Council's strategic plan and to enhance the success of students in higher education, THECB will adopt rules to develop summer higher education bridge programs in mathematics, science, and English-language arts, incentive programs for higher education institutions to implement research-based, innovative developmental education initiatives, financial assistance programs for educationally disadvantaged students who take college entrance and college readiness exams, professional development programs for college faculty, and other programs that support college participation and success.

Course redesign project. To improve student learning and reduce the cost of course delivery, THECB must implement a project under which selected higher education institutions will review and revise entry-level lower division academic courses. The project must be initiated by September 1, 2006, and participating institutions must begin offering these courses by September 1, 2007. By September 1, 2009, participating institutions must report the results of the project at that institution to THECB. By January 1, 2011, THECB must submit a summary report to the Legislature.

Other provisions

Uniform school start date. Under Education Code, sec. 25.0811, the school year currently cannot start before the week in which August 21 falls, unless a school district demonstrates community input about an earlier start date and receives a waiver from TEA. Beginning with the 2007-08 school year, HB 1 requires all schools to start the fourth Monday in August, unless the district operates a year-round system. School districts cannot obtain exemptions or waivers from the required start date.

Joint elections. School board elections must be held on the same date as the election for members of the governing body of a municipality located in the school district or the general election for city and county officers. The elections must be held as a joint election served by common polling places.

Textbooks. HB 1 directs the SBOE to forgo the issuance of textbook proclamations after the effective date of the bill, which states that the Legislature will implement reforms to the system of procuring and purchasing textbooks.

Electronic student records system. HB 1 requires public and charter schools and higher education institutions to participate in an electronic student records system approved by the education and higher education commissioners. The system must permit an authorized state or district official or an authorized representative of a higher education institution to electronically transfer information to and from an educational institution in which the student was enrolled and retrieve student transcripts, including information concerning a student's course or grade completion, teachers of record, assessment instrument results, receipt of special education services, and personal graduation plan. The education commissioner may solicit and accept grant funds to maintain the student tracking system and to make the system available to school districts. The records system must be in place by the beginning of the 2007-08 school year.

Technology Immersion Pilot Project. In 2003, the 78th Legislature established a three-year Technology Immersion Pilot Project to study the use of technology in participating schools and districts. HB 1 extends the project, which currently is scheduled to end in the 2006-07 school year, to the 2010-11 school year. The bill removes a prohibition against the use of general revenue funds for the project and a provision prohibiting TEA from spending more than \$1 million on the project and authorizes TEA to use undedicated and unobligated general revenue funds for the project.

Best practices clearinghouse. TEA, in coordination with the LBB, will establish an online clearinghouse of information relating to best practices of school districts regarding instruction, public school finance, resource allocation, and business practices. The information must be accessible to school districts and the public. TEA must hire one or more third-party contractors to develop, implement, and maintain a system of collecting and evaluating the best practices of campuses.

Optional flexible school day program. HB 1 allows school districts to operate flexible school day programs for students in grades 9 through 12 who have dropped out of school or are at risk of dropping out. A school district can provide flexibility in the number of hours and days a student attends and allow students to take less than full course loads. A course offered in a flexible program must provide for at least the same number of instructional hours required for a regular school program.

Tax notices. School tax bills must state in a distinct row or on separate lines proposed M&O tax rates, under the heading "Maintenance Tax" and taxes to pay for school district bonds, under the heading "School Debt Service Tax Approved by Local Voters." In addition to stating the total tax rate, a school tax bill or separate statement must separately state the M&O tax rate, bond debt rates, and total tax rates for the preceding year.

Texas governor's schools. A public senior college or university selected by TEA may administer a program and adopt rules governing summer residential programs, called Texas governor's schools, for high-achieving high school students. These programs may include curricula in mathematics and science, the humanities, or leadership and public policy. TEA must give preference to a college or university that applied in cooperation with a nonprofit association and would have to give additional preference if the nonprofit association received private foundation funds to finance the program. TEA can provide grants of up to \$750,000 per year to cover the costs of administering the program.

Education research centers. TEA and THECB may establish up to three centers for education research as part of TEA, THECB, or a college, junior college, or university. In conducting research, the centers will be authorized to use confidential data on student performance and must comply with confidentiality rules established by TEA and THECB.

Repeal of Rider 97. A provision in HB 1 repeals Rider 97 of TEA's fiscal 2006-07 appropriation, added during the first called session of the 79th Legislature, which had earmarked \$1.8 billion in general revenue for education-related purposes and school property-tax reduction, contingent on legislation authorizing such spending. By repealing the rider, that general revenue no longer is designated for a specific purpose.

TEA Sunset. HB 1 extends the date for TEA Sunset review from September 1, 2007, to September 1, 2012.

Effective date. HB 1 will take effect beginning with the 2006-07 school year, unless otherwise specified in the bill.

HB 3 - Revised Business Franchise Tax

Under the current franchise tax, as it exists until the implementation of HB 3 in 2008, the franchise tax applies only to for-profit corporations and, since 1991, to limited liability companies (LLCs) chartered or organized in Texas, as well as to foreign corporations and LLCs based or doing business in the state. Franchise taxpayers include professional corporations, banks, savings-and-loan associations, state-limited banking associations, and professional LLCs, but not limited partnerships, sole proprietorships, or non-corporate associations.

A dual-calculation method determines the amount of tax liability. Taxpayers pay the greater of a 0.25 percent tax on taxable capital (assets' net worth) or a 4.5 percent tax on earned surplus (modified net income). The income component generates the most revenue and is paid by about 75 percent of franchise taxpayers.

In recent years, several large Texas-based firms have reorganized as partnerships under state law to avoid paying the franchise tax. Firms accomplish this by forming wholly owned out-of-state subsidiaries in tax-friendly states such as Delaware, which has led to the nickname "Delaware sub" for the resulting entity. Typically, the subsidiaries enter into limited partnerships wherein the general corporate partner owns 0.1 percent of the operating assets in Texas and the limited partners own 99.9 percent. Under the comptroller's administrative rules, foreign corporations acting as limited partners are not considered to be doing business in Texas for tax purposes and thus are not subject to the franchise tax. The franchise tax liability of the general partner corporation typically is zero because its 0.1 percent interest fails to generate total receipts greater than the \$150,000 income threshold for tax liability.

A second accounting method used by some large firms is termed the "Geoffrey" loophole, named after the Toys R Us Inc. giraffe mascot. Under this method, corporations establish a subsidiary in another state that charges the Texas operations for the use of certain intangible assets, such as corporate trademarks. This method diverts money out of the Texas operations, and the franchise tax is applied only to what remains.

On November 4, 2005, Gov. Rick Perry appointed former Comptroller John Sharp to chair the Texas Tax Reform Commission comprising 24 business leaders,

academics, and other experts. The commission held hearings across the state throughout the winter and spring and released its report on March 29, 2006. Among its recommendations, the commission proposed a revised franchise tax designed to avoid the issues of avoidance and to minimize certain economic effects of the existing franchise tax. The commission's report served as a basis for HB 3, which the governor signed on May 19.

Overview. HB 3 by J. Keffer establishes a new mechanism for calculating the business franchise tax and revises the base of the entities subject to the tax. The revised tax takes effect January 1, 2008.

Under HB 3, the base of taxable entities subject to the revised franchise tax will include businesses in Texas that enjoy state liability protection, including corporations and limited liability partnerships. The revised tax excludes sole proprietorships, general partnerships that are owned directly by individual persons, certain unincorporated passive entities that only receive a limited amount of income from active business, and entities such as non-profit organizations that were exempt from the previous franchise tax. Businesses with no more than \$300,000 in total revenue, indexed for inflation, will be exempt from the tax, as will businesses that owe less than \$1,000 under the tax.

The revised tax will be computed by determining a taxable entity's total revenue. From this amount the entity can choose to deduct either its cost of goods sold or total compensation, up to \$300,000 per employee, indexed to inflation, plus benefits. If the entity's margin after making its deduction is greater than 70 percent of its total revenue, the business will be taxed on only 70 percent of its total revenue. The business will then apportion to the state the amount of revenue from business done in Texas and subtract any other allowable deductions to determine the entity's taxable margin.

Once the business's taxable margin is determined, a rate of 1 percent will be applied to that margin for all taxable entities that are not engaged in retail or wholesale trade. For a taxable entity that is engaged primarily in retail or wholesale trade, a rate of 0.5 percent will be applied to the entity's taxable margin.

Taxable entities. HB 3 defines “taxable entity” as a partnership, corporation, banking corporation, savings and loan corporation, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity. The definition of taxable entity does not include:

- a sole proprietorship;
- a non-corporate general partnership (i.e., a partnership directly owned by one or more individuals); or
- a passive entity.

An entity that could file its federal taxes as a sole proprietorship will not be considered a sole proprietorship if the entity enjoys liability protection from Texas or another state.

The definition of taxable entity also excludes an entity that was exempt from the previous franchise tax. This includes insurance companies required to pay insurance premium taxes, non-profit corporations, cooperatives, and credit unions. In addition, the definition of taxable entity excludes an entity that is not a corporation but that would have qualified for exemption under the previous franchise tax if it were a corporation, such as a nonprofit organization. An insurance company that otherwise would be exempt from the tax is subject to the tax if the insurance commissioner finds the company to have charged an excessive or discriminatory rate for automobile or residential property insurance.

Taxable entity also will not include a grantor trust, a natural person's estate, an escrow, a real estate investment trust, a real estate mortgage investment conduit, certain family limited partnerships, certain passive investment partnerships, and certain trusts that are passive entities.

A taxable entity is not required to pay the new tax if it owes less than \$1,000 under the tax or if the entity's total revenue is less than or equal to \$300,000. On January 1 of each odd-numbered year beginning in 2009, this \$300,000 threshold will be recalculated based on the percent change in the consumer price index during the preceding fiscal biennium, and the resulting amount will be rounded to the nearest \$10,000.

Exemption for passive entities. Passive entities are exempt from the new business tax. The bill would define “passive entity” as an entity that is a general or

limited partnership or trust, other than a business trust, at least 90 percent of whose income comes from investments, excluding rent or income received from mineral properties that are under a joint operating agreement in which a member of the group is the operator under that agreement. No more than 10 percent of the passive entity's federal gross income may come from active business. A royalty interest or non-operating working interest in a mineral right is not considered “active business.” Compensation payments to individuals for financial and legal services that are necessary for the entity's operation also do not constitute active business.

The bill establishes a test to determine whether an entity is conducting active business. Under the test, a business is considered to have conducted active business if the entity's activities include operations that earn income and if the entity performs active management and operational functions. Activities performed for the entity by an individual such as an independent contractor are considered activities performed by the entity if the individual performed services that constitute some part of the entity's business. If an entity uses its assets in the business of a related entity, that activity is considered active business.

Definition of total revenue. A taxable entity's tax liability under HB 3 is determined by computing the entity's “taxable margin.” An entity's “total revenue” is the base from which the entity's taxable margin is calculated. Upon determining an entity's total revenue, the entity deducts either cost of goods sold or compensation to determine its taxable margin.

For a corporation, partnership, or other taxable entity, total revenue is the sum of gross receipts and other income such as dividends, interest, rents, royalties, and capital gain income. From this amount, the entity subtracts items such as bad debt, foreign royalties and dividends, deductions allowed by the Internal Revenue Service, distributive income from partnerships, limited liability corporations, and “S” corporations, and certain other amounts.

If a taxable entity has an interest in a passive entity, that taxable entity includes its share of income from the passive entity, but only to the extent that the passive entity's net income is not generated by a separate taxable entity.

A management company will exclude reimbursements of costs incurred in its conduct of the business of the entity that it manages, including wages and cash compensation.

Total revenue exclusions. The bill enumerates several expenses and “flow-through funds,” or funds passed through a taxable entity to another entity, that are excluded from the total revenue of a taxable entity. This includes specific exclusions relevant to legal services entities and staff leasing entities. A taxable entity belonging to an affiliated group can not exclude such payments if they are made to another member of that group.

An amount excluded from total revenue may not be deducted as cost of goods sold or compensation in a taxable entity’s determination of its taxable margin. Dividends from federal obligations and bonds may be excluded from total revenue. In addition, a taxable entity may exclude revenue from operations at a federally owned facility that houses members of the armed forces. This amount could not also be deducted under the cost of goods sold or compensation deduction.

On dates during which the monthly average closing price of West Texas Intermediate crude oil is below \$40 per barrel, an entity may exclude total revenue from a well that produces less than 10 barrels a day over a 90-day period. On dates during which the monthly average closing price of natural gas is below \$5 per million British Thermal Units, an entity may exclude total revenue from gas produced from a well that yields less than 250 thousand cubic feet per day over a 90-day period.

Health care deduction. Health care providers may exclude some payments from total revenue for the purposes of calculating their business tax obligation. Providers may exempt the total amount of payments from Medicaid, Medicare, indigent health care, the Children’s Health Insurance Program (CHIP), workers’ compensation, and the TRICARE military health system. In addition, the cost of uncompensated services, at rates set by the comptroller, may be excluded from total revenue as long as audit requirements are met. Health care institutions, including hospitals, assisted living facilities, and others, may exempt 50 percent of those amounts.

Legal services deduction. Attorneys may deduct from total revenue up to \$500 in out-of-pocket expenses for each case of pro-bono legal service provided by an individual.

Determination of taxable margin. A taxable entity’s margin is determined by deducting either cost of goods sold or compensation from the entity’s total revenue.

Once a year, an entity will make an election on its annual report to subtract either cost of goods sold or compensation. In addition to either of these deductions, the company may deduct compensation paid to an active duty member of the armed forces as well as the cost of training the employee’s replacement.

If the difference after deduction is less than 70 percent of the entity’s total revenue, that amount is the entity’s margin. If the difference is greater or equal to 70 percent of the entity’s total revenue, the entity’s margin is 70 percent of its total revenue.

Upon determining its margin, an entity determines its “apportioned margin” by apportioning to Texas the proportion of business performed in this state, according to the bill’s apportionment rules. From this amount, the entity subtracts any other allowable deductions. The result is the entity’s “taxable margin.”

An entity may change its choice of deduction by filing an amended annual report.

Cost of goods sold. If an entity chooses the cost of goods sold deduction in determining its taxable margin, the bill authorizes deductions of all direct costs associated with the acquisition or production of goods. These include costs for such direct expenses as labor, materials, handling costs, storage costs, equipment leasing, depreciation associated with production of the goods, research, design, equipment maintenance, geological exploration costs, taxes stemming from the cost of production, and electricity costs.

The bill also allows for deduction of a contribution to a partnership partially owned by a taxable entity for activities that otherwise would be eligible for deduction as cost of goods sold. This provision applies only if those costs are related to goods obtained, rather than sold, by the taxable entity. Various other costs also are deductible, including deterioration and obsolescence of goods, certain preproduction costs, insurance costs related to the goods, utility costs used in production of the goods, quality control costs, and licensing costs. The bill specifies several costs that may not be included in cost of goods sold, including officer compensation.

Indirect and administrative overhead costs may be subtracted if the costs are allocated to the production of the goods. Such deductions can not exceed 4 percent of the entity’s total indirect and administrative overhead costs. A

lending institution may deduct interest expenses as cost of goods sold.

A motor vehicle leasing company, heavy construction equipment leasing company, or railcar rolling stock company may deduct as a cost of goods sold costs related to property that the entity leases in its ordinary course of business.

Compensation deduction. If an entity chooses the compensation deduction in determining its taxable margin, the bill authorizes the deduction of wages and cash compensation and benefits for each employee of an entity.

Wages and cash compensation includes the amount entered in the Medicare wages and tips box on an employees' W-2 tax form, as well as net distributive income accruing to a natural person from partnerships, trusts, limited liability corporations, and "S" corporations. Stock awards and options also qualify for deduction as wages and cash compensation. An entity may deduct no more than \$300,000 in wages and cash compensation per employee. On January 1 of each odd-numbered year beginning in 2009, the \$300,000 cap on the wages and cash compensation deduction will be adjusted based on the percent change in the consumer price index during the preceding fiscal biennium, and the resulting amount will be rounded to the nearest \$10,000.

In addition to the wages and cash compensation deduction, an entity may deduct all benefits provided to its employees, including workers' compensation, health care, retirement benefits, and employer health savings account contributions. The benefits deduction is not subject to the \$300,000 cap.

A management company may not include in its deduction of wages or cash compensation any amounts reimbursed by an entity it manages. A managed entity may deduct as wages or cash compensation reimbursements made to a management company as if those amounts had been made to its own employees.

Undocumented worker exclusion. Compensation paid to an undocumented worker for the production of goods may not be deducted as either compensation or cost of goods sold.

Calculation of tax. Under the bill, the revised franchise tax is computed by applying one of two rates to

a taxable entity's taxable margin, depending on the type of business activity in which the taxable entity primarily is engaged. If a taxable entity primarily is engaged in retail or wholesale trade, a rate of 0.5 percent is applied to the entity's taxable margin. If the entity is not engaged primarily in retail or wholesale trade, a rate of 1 percent is applied to the entity's taxable margin.

An entity primarily is engaged in retail or wholesale trade if:

- the total revenue from its retail and wholesale trade activities is greater than its total revenue from other activities;
- less than 50 percent of its total revenue in retail or wholesale trade comes from the sale of products it produces (excluding eating and drinking establishments); and
- the entity does not provide utilities, including telecommunications, electricity, or gas.

Any increase in the rate of the revised business tax must be approved by a majority of voters in a statewide referendum. If the rate is decreased, any subsequent increase from the new rate must be approved by voters. Changes to the administration, enforcement, applicability, or computation of the tax do not require voter approval.

Combined reporting. Under HB 3, a group of two or more taxable entities must report as a single entity if the entities are part of an affiliated group as defined by a common ownership test and are engaged in a unitary business. The combined group will determine its total revenue and elect to deduct either cost of goods sold or compensation to establish the group's taxable margin.

Tiered partnership arrangements. The bill allows a taxable entity that is a lower tier entity to pay the tax of a higher tier partnership if the partnership reports to the comptroller the amount of taxable margin that each lower tier entity should include in the taxable margin of each lower tier entity, as determined by the profits interest of the lower tier entity.

Apportionment. A taxable entity's proportion of business performed in Texas will be apportioned to the state to determine the entity's tax liability. The taxable entity's margin is apportioned to Texas by multiplying the entity's margin by the quotient of:

- the taxable entity's gross receipts from business done in Texas; divided by
- the taxable entity's gross receipts from its entire business.

A combined group must include in its gross receipts from business done in Texas the gross receipts of each taxable entity that is a member of the combined group that has nexus (business connection) in Texas. In determining a combined group's total gross receipts, the combined group must include the gross receipts of each entity that is a member of the group, whether or not the member has nexus in Texas.

In apportioning margin, exclusions taken by an entity when determining the entity's total revenue cannot be included in the entity's receipts in Texas or receipts from the entity's entire business. Receipts from the sale of property between one member of a combined group with nexus in Texas and another member of the combined group with nexus outside Texas will be included in the receipts of business done in Texas by the taxable entity, provided that the member that does not have nexus in Texas resells the property to a purchaser in Texas.

Penalties. The comptroller is authorized to forfeit the right of a taxable entity to transact business in the state in the same manner that the comptroller could forfeit a corporation's corporate privileges under the previous franchise tax.

Texas Economic Development Act. HB 3 extends the Texas Economic Development Act, a program that allows a school district to offer tax abatements to companies investing in the district. The program, due to expire December 31, 2007, is extended until December 31, 2011. The program will apply to an entity to which the new business tax applies. Under the program, impact evaluations will be conducted by the Texas Education Agency (TEA) rather than by a third party. TEA's analysis will be binding on the school district and the applicant.

Other provisions. The bill contains provisions for the transition of existing franchise taxpayers to the new franchise tax established under the bill. Franchise tax credits existing under current law are repealed. A taxable entity receiving credit on net taxable earned surplus under the previous franchise tax will be able to notify the comptroller of its intent to preserve credits on tax due on its taxable margin.

A taxable entity that owes the franchise tax under the bill must file an initial informational report with the comptroller and an annual report containing information necessary to compute the tax on the taxable entity.

The bill requires an informational report from each of the 1,000 entities that paid the most franchise tax in calendar year 2005 under the existing franchise tax, the 1,000 entities that had the greatest gross receipts in 2005, and the 1,000 entities with the most employees in the state in 2005. This information will be used by the comptroller to report to the governor, the lieutenant governor, and the Legislature the amount of revenue that would be generated from the entities if the new franchise tax were in effect on January 1, 2006. This report must be delivered by April 1, 2007.

A taxable entity with more than 100,000 employees in the state annually must report the number of its employees in the state receiving assistance under Medicaid or CHIP.

The bill specifies that the franchise tax as amended by HB 3 is not an income tax and federal law concerning state taxation of income from interstate commerce does not apply. Any lawsuit contending that the new franchise tax established under HB 3 is unconstitutional would be heard in the Texas Supreme Court.

Revenue from the tax imposed under the bill will go into the state's general revenue fund. The bill appropriates \$2 million in general revenue to the comptroller for fiscal 2006-07 for audit and enforcement activities.

The tax imposed under the bill takes effect January 1, 2008, and applies to reports due on or after that date. The bill takes effect September 1, 2006.

According to the LBB, HB 3 will result in revenue gains of \$3.4 billion in fiscal 2008 and \$3.5 billion in fiscal 2009. These figures are in addition to the amounts the state would have collected in these years if the previous franchise tax had remained in effect.

HB 4 – Determining Motor Vehicle Value for Sales Tax Purposes

HB 4 by Swinford addresses the problem of under-reporting of sales prices of motor vehicles in calculating the 6.25 percent motor vehicle sales-and-use tax.

The bill requires the Texas Department of Transportation to determine for vehicle sales tax purposes the “standard presumptive value” – or private-party transaction value – of a motor vehicle based on a regional guidebook of a national industry reporting service or other appropriate publication. The department must maintain the standard presumptive values of vehicles in its registration and title system, update the data at least quarterly, and publish the updated information. These data must be made available to county tax assessor-collectors.

Effective October 1, 2006, a county tax assessor-collector must use the amount paid for a motor vehicle to assess the state’s 6.25 percent sales-and-use tax on the purchase if the amount paid is at least 80 percent of the vehicle’s standard presumptive value. If the amount paid for the motor vehicle is less than 80 percent of the standard presumptive value, the county tax assessor-collector must assess the tax on 80 percent of the vehicle’s value. The county tax assessor-collector may assess the sales-and-use tax on an amount less than 80 percent of the standard presumptive value only if the retail value is shown on:

- a receipt or invoice provided by a motor vehicle dealer;
- a certified appraisal performed by a motor vehicle dealer; or

- a certified appraisal performed by a licensed adjuster.

If the individual provides such information, the tax will be levied on the retail value shown on the receipt, invoice, or appraisal. If the seller chooses to present a certified appraisal, that appraisal must be presented by the purchaser to the tax assessor-collector within 20 working days after the vehicle is delivered to the purchaser.

The bill requires a motor vehicle dealer to provide a certified appraisal of the retail value of a motor vehicle, for which the dealer may charge a fee to be determined by the comptroller.

These requirements do not apply to transactions involving an even exchange of vehicles or to a gift. The bill also does not apply to abandoned or disposed motor vehicles.

The standard presumptive value provision in HB 4 takes effect October 1, 2006. The remainder of HB 4 takes effect August 14, 2006.

According to the LBB, HB 4 will result in gains to the state of \$30.6 million in fiscal 2007, \$42.3 million in fiscal 2008, and \$42.8 million in fiscal 2009. These figures are in addition to vehicle sales tax revenue the state would have collected in these years if the standard presumptive value provision had not taken effect.

HB 5 – Increased Tax on Cigarettes and Other Tobacco Products

Beginning January 1, 2007, HB 5 by Hamric increases tax rates for cigarettes and other tobacco products, excluding cigars. The bill increases the cigarette tax rate by \$1.00, from 41 cents to \$1.41 per pack. The other tobacco products tax rate will rise from 35.21 percent to 40 percent of the manufacturer’s list price.

As of January 1, 2006, cigarette tax rates per pack in states bordering Texas were 91 cents in New Mexico,

\$1.03 in Oklahoma, 59 cents in Arkansas (plus a dealer enforcement/administration fee), and 36 cents in Louisiana.

According to the LBB, HB 5 will result in gains to the state of \$431.7 million in fiscal 2007, \$690.9 million in fiscal 2008, and \$731.3 million in fiscal 2009. These figures are in addition to the amounts the state would have collected in these years if the previous tobacco taxes had remained in effect.

HB 2 – Dedicating New Tax Revenue to School Property Tax Reduction

HB 2 by Pitts creates a property tax relief fund outside of general revenue for the collection of revenue generated by the new taxes authorized by the 79th Legislature during the third called session. Beginning in fiscal 2008, the revenue in this fund must be appropriated to reduce school district maintenance and operations (M&O) tax rates to at least \$1.00 per \$100 valuation. Any money remaining after M&O taxes reach \$1.00 must be spent two-thirds for additional M&O tax reduction and one-third to increase the level of equalization of school districts' enrichment tax effort.

Revenue deposited to this fund may be appropriated only to reduce M&O school tax rates to rates below those in effect January 1, 2006, until they reach an average of \$1.00 per \$100 of taxable value. In a tax year when average school M&O tax rates are \$1.00 or below, two-thirds of the money in the property tax relief fund remaining after a sufficient amount is appropriated to maintain the \$1.00 per \$100 M&O rate may be appropriated for additional tax rate reduction, and one-third may be appropriated only to increase the equalization in the school tax enrichment tier established in HB 1 by Chisum. Monies from the property

tax relief fund must be distributed in a way that does not increase disparities in revenue yield by districts of varying property wealth per weighted student.

The revenue earmarked for the new fund includes the amount of revenue from any new business tax (HB 3 by J. Keffer) collected by the state in excess of the amount that the comptroller estimates the current franchise tax would have generated. The revenue generated from the computation of the tax on the standard presumptive value of motor vehicles (HB 4 by Swinford) and from cigarette and tobacco taxes (HB 5 by Hamric) higher than the current rates also must be deposited in this fund.

The property tax relief fund will be exempt from Government Code, sec. 403.095, which "sweeps" into general revenue money in state funds left unappropriated at the end of the fiscal biennium for purposes of certifying the state budget. Interest and income derived from the fund will be allocated monthly to the fund.

HB 2 takes effect September 1, 2006.

Appropriations in the Third Called Session

During the third called session, the 79th Legislature appropriated approximately \$4 billion for fiscal 2006-07.

HB 1 by Chisum appropriates a total of \$3.9 billion from the foundation school fund and general revenue to TEA for fiscal 2007 to provide additional funding over current appropriated levels. This will cover the cost of the property tax cut and hold harmless provisions, equalization in existing school funding formulas and in the new enrichment tier, a \$2,000 teacher pay raise, a new high school allotment of \$275 per student, and a variety of new programs and initiatives authorized by the bill.

HB 63 by Pitts appropriates \$34 million from general revenue to Lamar University in fiscal 2007 for payments of costs to repair damage from hurricanes Katrina or Rita. The first \$34 million in federal funds received for the

same purpose will be allocated to state general revenue. Any additional federal funds will be allocated to Lamar University and could be used to cover hurricane-related losses, including damages and costs related to disruption of activities.

HB 153 by Morrison appropriates \$5.3 million from general revenue for fiscal 2006-07 to the University of Texas System to reimburse debt service paid on long-term obligations used for the construction of a natural science and engineering research building at the University of Texas at Dallas.

HB 3 by J. Keffer appropriates \$2 million from general revenue in fiscal 2007 to the Comptroller's Office for implementation of the business tax bill and for audit and enforcement activities.

According to the LBB, the additional state spending authorized during the third called session does not exceed the constitutional limit on the growth in state spending. Texas Constitution, Art. 8, sec. 22, caps growth in spending of undedicated state tax revenue. It may not exceed the LBB's official estimate of the growth rate of the

state's economy. The LBB estimates that total budgeted spending for fiscal 2006-07, including the additional funds appropriated by the Legislature during the third called session, is within \$100 million of the constitutional spending cap.

Fig. 1: Total appropriations from legislation enacted in the third called session
(all figures in millions)

	fiscal 2006-07	projected fiscal '08	projected fiscal '09
HB 1			
Property tax cut	\$2,100	\$6,600	\$6,900
Hold harmless	65	–	–
Pay increase	802	817	831
High school allotment	319	325	332
Equalization	478	629	940
Educator Excellence Awards	100	261	317
Spending shift repeal	–	–	800
Other	58	63	11
Total HB 1	3,922	8,695	10,131
HB 63 – Hurricane damage	34	–	–
HB 153 – TRB debt service payments	5	166	167
HB 3 – Comptroller audit and enforcement	2	4	4
Total	\$3,963	\$8,865	\$10,302

Fig. 2: Total revenues from legislation enacted in the third called session
(all figures in millions)

	projected fiscal 2006-07	projected fiscal '08	projected fiscal '09
HB 3 – Revised business franchise tax	–	\$3,387	\$3,454
HB 4 – Vehicle value for sales tax purposes	31	42	43
HB 5 – Cigarette and other tobacco taxes	432	691	731
Total	\$463	\$4,120	\$4,228

Source: Legislative Budget Board

Other Legislation Enacted in the Third Called Session

HB 153 – Tuition revenue bonds for higher education institutions

Background. Tuition revenue bonds (TRBs) are issued by institutions of higher education for which future revenue (tuition and fees) is pledged for repayment of the bonds. The Legislature must authorize bond issuance, and bond proceeds generally are used to finance institutional construction, renovation projects, equipment, and infrastructure. The authorization and issuance of the bonds is not contingent on an appropriation for related debt service, but the Legislature historically has appropriated general revenue to reimburse institutions for the tuition used to pay for the debt service — principal and interest. However, the 78th Legislature in 2003 appropriated funds to pay only for interest on TRBs issued after March 31, 2003.

In 2005, the 79th Legislature in SB 1 by Ogden, the general appropriations act for fiscal 2006-07, appropriated \$374.9 million for principal and interest for existing TRBs issued through the end of fiscal 2005. That same session, HB 2329 by Morrison, which would have authorized a total of \$2.2 billion in new TRBs for higher education institutions, died when neither house adopted the conference committee report. Sec. 14.61 of Article 9 of SB 1 included \$108 million for TRB debt service, contingent on passage of HB 2329 or similar legislation. Gov. Perry line-item vetoed this provision because HB 2329 was not enacted.

During the first and second called sessions of the 79th Legislature, the House passed HB 6 by Morrison, which would have authorized \$2.7 billion and \$2.75 billion respectively in TRBs. In each session, the bill died in the Senate.

HB 153 by Morrison. HB 153 authorizes the issuance of \$1.8 billion in TRBs for institutions of higher education to finance construction and improvement of infrastructure and related facilities. It does not make an appropriation for debt service for the bonds. The bonds will be payable from pledged revenue plus tuition and, if a board of regents did not have sufficient funds to meet its obligations, funds could be transferred among institutions, branches, and entities within each system or university.

The bill includes TRB authorization for individual institutions and projects in the following university systems:

- University of Texas System (\$846 million);
- Texas A&M University System (\$465 million);
- University of Houston System (\$131 million);
- University of North Texas System (\$117 million);
- Texas Tech University System (\$90 million);
- Texas State University System (\$97 million);
- Texas Southern University (\$46.5 million);
- Stephen F. Austin University (\$30.2 million);
- Texas Woman's University (\$21.7 million);
- Midwestern State University (\$10.4 million); and
- Texas State Technical College System (\$3 million).

HB 153 prohibits the issuance of bonds for facilities at Texas A&M University's Central Texas and San Antonio campuses and at the University of North Texas' Dallas campus until enrollment at each campus reaches 1,500 full-time students for one semester. If enrollment fails to reach this level by January 1, 2010, the university system's authority to issue bonds for improvements at the campus expires. Likewise, the bill prohibits Texas Southern University from issuing bonds for a branch campus multi-purpose academic center until the Texas Higher Education Coordinating Board approves the operation of a branch campus. If the board does not grant approval by January 1, 2010, the university's authority to issue bonds expires.

The bill also appropriates \$5.3 million to the University of Texas System for the remainder of fiscal 2006-07 to reimburse debt paid on long-term obligations for the construction of a natural science and engineering research building at the University of Texas at Dallas. In addition, from fiscal 2008 through fiscal 2017, the bill sets a yearly limit of \$6.5 million for any future appropriations for this project. Annual appropriations will begin to phase out in fiscal 2018, and the bill caps the yearly appropriation at \$654,060 in fiscal 2027.

HB 153 also adds junior college districts with a total headcount enrollment of 40,000 or more to the statutory list of entities eligible to issue obligation bonds.

The LBB estimates that debt service costs on the TRBs will be about \$160 million in fiscal 2008.

HB 154 – Transfer of Irma Rangel Pharmacy School administration

Background. In an effort to address the shortage of pharmacists and meet the health needs of Texans, particularly residents of South Texas, the 77th Legislature in 2001 enacted HB 1640 by Rangel, which established a college of pharmacy at Texas A&M University - Kingsville. The Legislature also authorized \$14.5 million in tuition revenue bonds to finance construction of the building. The 78th Legislature in 2003 appropriated \$306,250 for curriculum development for the school of pharmacy and named it for the late Rep. Irma Rangel. The university borrowed approximately \$3 million in funds from the Texas A&M University System to hire faculty, begin curriculum development, and meet accreditation requirements. The pharmacy school was completed in June 2005 but the fall 2005 opening was delayed until the fall of this year due to a lack of operational funding.

In August 2005, Gov. Perry through budget execution authority proposed spending \$10 million for operational

costs for the pharmacy college, but the governor's proposal expired when the Legislative Budget Board took no action on it. In March 2006, the Texas A&M Health Science Center agreed to contribute \$6 million to open the school for classes starting this fall. The Texas A&M Board of Regents subsequently transferred management of the Rangel School from Texas A&M-Kingsville to the Health Science Center.

HB 154 by Luna. HB 154 transfers the administration of the Irma Rangel School of Pharmacy from Texas A&M University - Kingsville to the Texas A&M University System Health Science Center. It allows the Texas A&M University System Board to maintain the school in Kleberg County as a component of the Texas A&M University Health Science Center and repeals the authorization of the Texas A&M University System Board to maintain the school as part of the Texas A&M University - Kingsville. The bill authorizes the facility to offer courses and degrees that are comparable with other colleges of pharmacy.

HB 149 - State title to carbon dioxide from FutureGen clean coal project

HB 149 by Chisum aligns Texas law with standards put forward in the U.S. Department of Energy's FutureGen program request for proposals. FutureGen is a federal initiative of the U.S. Department of Energy to build a coal-based integrated sequestration and hydrogen project and eventually create a zero-emissions fossil fuel – or “clean coal” – plant. The prototype plant would attempt to establish the technical and economic feasibility of producing electricity and hydrogen from coal while capturing and sequestering the carbon dioxide produced in the process. Texas has submitted two FutureGen host site proposals to the Department of Energy and the FutureGen Industrial Alliance, one in Odessa in West Texas and one in Jewett in East Texas.

Under the bill, the Texas Railroad Commission (TRC) will acquire title to carbon dioxide produced by a clean coal project. The transfer of this title will be made without cost, other than the administrative and legal costs. TRC will administer the interest conferred under the bill in the name

of the state of Texas. This transfer does not relieve the owner or operator of a clean coal project of liability for an act performed before the carbon dioxide is captured.

The bill also allows TRC to sell carbon dioxide that is captured by a clean coal project and not injected for storage in a geologic formation. This carbon dioxide may be sold for enhanced oil recovery or another beneficial use. Proceeds for the sale would go to the general revenue fund.

The bill also allows the University of Texas (UT) System and Permanent University Fund (PUF) to enter into a lease to allow the use of UT System or PUF lands for permanent storage of carbon dioxide captured by a clean coal project. Such a lease will have to indemnify the UT System and PUF against liability incurred as a result of carbon dioxide that escaped after it had been injected.

HB 149 takes effect September 1, 2006.

HB 163 – Authorizing securitization financing for Entergy to recover hurricane reconstruction costs

HB 163 by P. King authorizes Entergy Corp., an electric provider in Southeast Texas outside the Electric Reliability Council of Texas (ERCOT), to use securitization financing to recover reconstruction costs associated with the restoration of service stemming from power outages caused by Hurricane Rita in September 2005.

Securitization financing is a debt management method that allows a utility to sell its debt to a third party. The utility receives from investors a lump-sum payment equaling the amount of debt sold. The investors then issue securities. Utility customers pay the principal and interest payment on the securitized debt instead of paying the cost on their electric bills over time. This mechanism allows debt to be refinanced at potentially lower rates, cutting the total cost of debt.

Entergy may petition the Public Utility Commission (PUC) to issue an order determining the amount of hurricane reconstruction costs that are eligible for recovery and securitization. After receiving the PUC order on eligible

hurricane reconstruction costs, Entergy may apply for a financing order detailing the costs to be recovered and approving the issuance of bonds.

“Hurricane reconstructions costs” include costs incurred in connection with the restoration of service following power outages caused by Hurricane Rita, including the repair and reconstruction of generation, transmission, distribution, or general plant facilities. Any insurance proceeds, governmental grants, or other compensation funding the utility’s reconstruction costs will reduce the amount of the utility’s costs that were recoverable from customers.

Hurricane reconstruction costs will be allocated to customers in the utility’s base rates. If the PUC determines that securitization is not beneficial to the utility’s ratepayers, the utility is authorized to recover its hurricane reconstruction costs through a customer surcharge. Entergy is authorized in its next rate proceeding to recover hurricane reconstruction and other costs that it had not yet incurred at the time of its application to the PUC.

HB 97 – Banning disruptive protests at funerals

HB 97 by McCall bans disruptions within 500 feet of a cemetery or facility hosting a funeral during the service as well as during the hour preceding and following the event. The offense is a class B misdemeanor (up to 180 days in jail and/or a maximum fine of \$2,000). Violators protesting in a nonviolent manner would have a defense to prosecution if prior to arrest they were not ordered to move, an order to move was manifestly unreasonable, or the order to move was promptly obeyed.

Prompted by the actions of a religious congregation from Kansas that has protested military funerals across the nation, Texas becomes the fifteenth state to enact such limits on funeral disruptions.

HB 97 took effect May 19. On May 24, Congress approved legislation (H.R. 5037) governing military funerals at the 122 national cemeteries, including six in Texas, that would bar protests within 300 feet of the entrance and 150 feet of any road leading to a cemetery from an hour before the service to an hour after it. Violators could be punished with a fine of up to \$100,000 and one year in prison.

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