SPECIAL FINANCIAL REPORT

JOHN SHARP
Texas Comptroller
of Public Accounts

January 1997

A report to the Governor and Texas Legislature

Sales and Franchise Tax Exemptions

In fiscal 1997—the year between September 1, 1996, and August 31, 1997—sales and franchise tax exemptions will amount to a total of $15.3 billion.

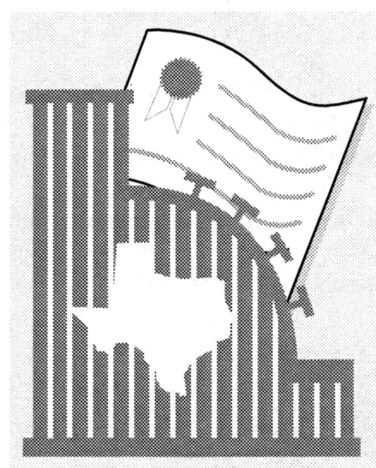
Sales tax exemptions will total $14.6 billion. Franchise tax exemptions will total $700.7 million.

These amounts include exemptions, exclusions, special rates, deductions and discounts written into the state's sales and franchise tax laws.

Sales tax exclusions for services alone will be worth an estimated $2.6 billion in 1997.

Franchise tax exemptions go to both profit-making and nonprofit businesses. In 1997 these will total $570.3 million and $130.4 million, respectively.

At $10.8 billion, the sales tax was the state's biggest single source of tax revenue in the 1996 fiscal year. Franchise tax ranked fourth, with net receipts of $1.6 billion from corporations doing business in Texas. Together, sales and franchise taxes accounted for 63 percent of the state's tax revenue.



About the estimates

Texas law requires the Comptroller to provide these estimates to the Governor and the Legislature prior to each regular legislative session. The exemption estimates are unadjusted amounts, meaning that elimination of a specific exemption would not necessarily produce the exact dollar amounts cited in this report. Actual receipts would depend on enforcement, taxpayer compliance, effective dates and taxpayer discounts.

Each estimate is based on the best information available from public and private sources, including the Comptroller's tax records. The report is informational. It contains no recommendations related to the exemptions estimated. ✪

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A Message From The Comptroller

January 14, 1997

The Honorable George W. Bush
The Honorable Bob Bullock
The Honorable James E. "Pete" Laney
Members of the 75th Legislature

Ladies and Gentlemen:

As required by Sec. 403.014 Texas Government Code, this report estimates the value of each exemption, exclusion, special rate, deduction and discount available under Texas' sales and franchise tax laws.

In fiscal 1997 sales and franchise tax exemptions will total an estimated $15.3 billion. Of this total, sales tax exemptions will account for $14.6 billion, and franchise tax exemptions will account for $700.7 million.

The report makes no recommendations for retaining, eliminating or amending any provisions of these laws. It is intended as an informational resource for the Governor and Legislature.

Respectfully,

JOHN SHARP
Texas Comptroller of Public Accounts

Sales Tax

The limited sales and use tax

The sales tax is the largest source of tax revenue for Texas state government, bringing in about 55 cents of every state tax dollar. The sales tax is a tax on transactions. In general, the tax is imposed on final sales, rentals and leases of tangible personal property—physical goods—and on sales of some services, such as repair of tangible personal property, amusement services and telephone services.

While total sales tax collections were $10.8 billion in fiscal 1996, the tax is limited in scope compared with the total number and kind of transactions in the economy. The tax is limited by a host of exemptions and exclusions provided by law.

Classifying sales tax exemptions

Sales tax exemptions can be divided into three general categories: exemptions, exclusions and discounts.

An *exemption* protects items that would be taxable except for specific provisions in the law. For example, since the general legal definition taxes all sales of tangible personal property, groceries would be taxable if they were not specifically exempted.

Exclusions are transactions not taxed because they fall outside the general legal definition of a taxable sale, or because taxing them would result in multiple taxation of the same items. Exclusions include the sales of intangibles, such as stocks and bonds, sales and rentals of real property, sales for resale and sales of materials incorporated into manufactured products.

Also excluded from the tax base are most services. Currently, some specified services are listed as taxable items. Also, items taxed under other laws are typically excluded from the general sales tax.

Discounts are handling fees that Texas law lets tax-permit holders keep in exchange for collecting the sales tax and sending it to the state on time. The standard discount is 0.5 percent of the sales tax collected. An additional 1.25 percent discount is available to those who pay their estimated tax collections in advance.

Exemptions have been established for some basic necessities, such as groceries, residential gas and electric utilities and prescription medicines. Some sales are exempted when made to certain groups. For example, governmental bodies and religious and nonprofit educational groups buy items for their own use tax-free.

Other exemptions apply because the tax would be impractical to collect. For example, those who make only occasional sales (one or two sales of taxable items per year) do not collect the tax.

Most other exemptions and exclusions prevent multiple taxation of the same items or lower business costs.

Business exemptions

Some business exemptions are general and benefit most kinds of business, such as the exemption for containers (worth $67.8 mil-

Estimated cost of sales and franchise tax exemptions, exclusions and discounts, fiscal 1997

Millions of dollars

Sales Tax	
Amount	
Exemptions	$ 3,366.9
Services exclusions	2,644.1
Other exclusions	8,539.5
Discounts	78.0
Total, sales tax	14,628.5
Franchise Tax	
Profit-making corporations:	
Exemptions	186.8
Special rates	0.0
Deductions	362.4
Special accounting	18.2
Credits	2.9
Nonprofit corporations	130.4
Total, franchise tax	700.7
TOTAL	**$15,329.2**

Totals may not add due to rounding.
SOURCE: John Sharp, Texas Comptroller of Public Accounts.

lion in 1997). Others affect specific industries.

Agriculture receives exemptions for machinery and equipment, livestock, feed, seed, fertilizer, pesticides, gas and electricity, commercial fishing ice, and certain containers. These agricultural exemptions will be worth a total of $338.9 million in fiscal 1997.

Major sales tax exemptions and exclusions, fiscal 1996

	Number of states exempting[1]	Exempt in Texas?
Consumer goods		
Groceries	25	yes
Prescription drugs	43	yes
Services		
Residential gas	29	yes
Residential electricity	30	yes
Water		
Industrial	30	yes
Residential	37	yes
Access to online services[2]	33	no
Laundry and dry cleaning	23	no[3]
Barber and beauty services	41	yes
Funeral services	40	yes
Local advertising, radio & TV	43	yes
Legal services	42	yes
Physician services	43	yes
Dental services	43	yes
Accounting and audit services	42	yes
Real & personal property sales agents	42	yes
Engineering	42	yes
Temporary help agencies	37	yes
Service charges on checking accounts	43	yes
Travel agent services	42	yes
Automotive maintenance and repair	25	yes[4]
Automotive washing	27	yes
Pet grooming	30	no
Veterinary services	41	yes
Agricultural goods		
Feed, seed, fertilizer, etc	45	yes
Agricultural machinery	32	yes
Business goods		
Sales for resale	44	yes
Production machinery	32	yes
Manufactured raw materials used in processing	44	yes
Raw materials used in processing	45	yes

1 Forty-five states impose a general sales tax.
2 Taxability under review in 3 additional states.
3 Coin-operated laundry services are exempt.
4 Parts are taxable; labor is exempt.

SOURCES: Commerce Clearing House, Multistate Sales Tax Guide; Federation of Tax Administrators, Sales Taxation of Services, An Update, November 1996 draft.

Oil and gas exploration and production businesses receive exemptions for gas and electric power ($39.9 million) and drilling equipment used offshore ($20.9 million).

Contractors who work on projects for government or certain other exempt organizations may purchase materials and certain services tax-free ($10.6 million).

The vending machine industry receives an exemption for receipts from coin-operated amusement machines worth $27.4 million. Although not completely exempted, the sale of edible items, excluding soft drinks and candy, sold through vending machines receive what amounts to a partial exemption ($6.0 million in 1997). Vendors of edible items calculate the sales tax due based on 50 percent of the gross receipts from the sale of these items. (Coin-operated amusement machine owners pay a tax—worth approximately $6.0 million in fiscal 1996—based upon the number of machines operated.)

Many items used by transportation businesses also are exempt. Airlines purchase aircraft trainers and simulators ($0.1 million), aviation fuel ($110.2 million) and repair equipment ($11.6 million) tax-free. Certain commercial ships, parts and repair remain untaxed ($25.4 million). And railroads pay no sales tax on the purchase of locomotives and rail cars ($1.4 million), or on fuel, parts and supplies ($5.4 million). Most sales of aircraft and railroad rolling stock are for use in interstate commerce and would escape sales tax even if the exemptions were repealed. Sales of gas and electric power ($348.0 million) and wrapping and packaging materials ($87.2 million) used in manufacturing are exempt.

The Legislature, in 1987, authorized an exemption for certain items of manufacturing machinery and equipment. The state sales tax on these purchases has been phased out beginning with purchases made during calendar year 1990.

As of January 1, 1995, eligible purchases of manufacturing machinery and equipment became completely exempt from state and local sales taxes. Two recently decided court cases will have the effect of expanding the definition of machinery and equipment which will qualify for this exemption. The state sales tax exemption for these items in fiscal year 1997 is estimated to be worth $336.1 million.

Services exclusions

For most of its history, the sales tax was not imposed on sales of services. But beginning in the mid-1980s, some services have become subject to sales tax.

In 1984, sales tax was imposed on laundry and dry cleaning, amusement admissions, cable television service, auto parking, most non-automotive repair services and some other personal services such as massage parlors.

The following year, the tax was extended to intrastate long-distance phone service.

In 1987, a number of other services were added to the sales tax base, including local and interstate long-distance telephone service, repair and remodeling of nonresidential real property, data processing, landscaping and lawn maintenance, janitorial and extermination services, security services, garbage removal, credit reporting and debt collection, information services, land surveying and certain insurance services.

Many services remain excluded from tax. Total service exclusions will be worth about $2.6 billion in fiscal 1997, an amount equal to 23 percent of expected state sales tax collections.

The largest service exclusions are for professional services. These include medical, dental and other health care ($718.8 million), legal services ($273.2 million), accounting and audit services ($92.6 million), engineering and architectural services ($178.6 million), real estate brokerage ($74.9 million), financial securities brokerage ($71.2 million) and veterinary services ($18.7 million).

Labor charges by contractors on new residential and nonresidential construction jobs are not taxable ($255.5 million). And labor for residential repair and remodeling remains tax-free ($42.2 million).

Other business services that are not taxed

Estimated cost of sales tax exemptions and exclusions, fiscal 1997

Millions of dollars

Item	Amount
Food for home consumption	$ 908.8
Manufacturing gas and electricity	348.0
Residential gas and electricity	499.7
Property used for the improvement of exempt realty	10.6
Agricultural feed, seed, chemicals and supplies	187.7
Sales to governmental entities	155.3
Prescription medicine and devices	126.5
Livestock for food	93.6
Water	142.5
Manufacturing machinery and equipment	336.1
Packaging and wrapping supplies	87.2
Aviation fuel	110.2
Agricultural manufacturing machinery and equipment	36.7
School lunches and certain food sales	27.3
Containers	67.8
Certain drilling equipment	20.9
Coin-operated amusements	27.4[1]
Certain ships	25.4
Agricultural gas and electricity	12.0
Newspaper inserts	18.0
Magazine subscriptions	24.3
Repair equipment for certain aircraft	11.6
Sales to non-profits	12.8
Railroad fuel and supplies	5.4
Newspapers	12.4
Horses, mules and work animals	7.6
One day sales	2.9
Religious writings	3.7
Mining gas and electricity	39.9
Rolling stock and locomotives	1.4
Commercial fishing ice	0.9
Equipment used in enterprise projects	1.6
Timber equipment	0.4
Agricultural containers	0.4
Certain aircraft	0.1
Exemptions required by prevailing law	n/a
Previously taxed items	n/a
Intercorporate sales of services	n/a
Sales for resale	n/a
Occasional sales	n/a
Sales by or to Indian tribes	n/a
Transfers of common interests in property	n/a
Texas Hospital Equipment Financing Council	n/a
TOTAL–EXEMPTIONS AND EXCLUSIONS	**$3,366.9**

[1] Coin-operated amusement machines are taxed under a separate tax based upon the number of machines operated.

n/a Not estimated due to data limitations or negligible size.

Totals may not add due to rounding.

SOURCE: John Sharp, Texas Comptroller of Public Accounts.

include advertising ($122.7 million); custom computer programming ($50.0 million); management consulting and public relations ($69.3 million); employment agency, temporary labor supply and other personnel services ($72.2 million) and intrastate freight hauling ($170.9 million).

Estimated cost of services excluded from the sales tax base, fiscal 1997
Millions of dollars

Item	Amount
Construction labor	
New residential construction	$130.1
New non-residential construction	125.4
Residential repair and remodeling	42.2
Personal services	
Barber and beauty services	36.2
Funeral services	25.0
Coin-operated laundry	6.5
Child day care	43.5
Miscellaneous personal services	9.3
Business and professional services	
Physicians services	407.3
Dental services	120.0
Other health care	191.5
Legal services	273.2
Accounting and audit services	92.6
Architectural and engineering services	178.6
Management consulting and public relations	69.3
Custom computer programming	50.0
Research and development laboratory services	21.0
Economic and sociological research	10.5
Testing labs	23.8
Advertising media	122.7
Employment agency services	23.8
Temporary labor supply	48.4
Financial services brokerage	71.2
Other financial services	49.4
Real estate brokerage and agency	74.9
Freight hauling	170.9
Other transportation (except scheduled passenger)	8.0
Veterinary services	18.7
Other services	
Automotive maintenance and repair	141.8
Car washes	11.5
Travel arrangement	22.3
Private vocational education	11.0
Other private educational services	9.0
Interior design	4.4
TOTAL–SERVICES EXCLUDED	**$2,644.1**

Totals may not add due to rounding.

SOURCE: John Sharp, Texas Comptroller of Public Accounts.

Personal services not taxed include beauty and barber service ($36.2 million), funeral services ($25.0 million), child day care ($43.5 million) and coin-operated laundry ($6.5 million).

Automotive maintenance and repair ($141.8 million), car washing ($11.5 million) and travel arrangement services ($22.3 million) remain tax-free. Other untaxed services include certain educational services ($20.0 million) and interior design ($4.4 million).

Other exclusions

Intermediate sales of goods to businesses are generally excluded from the tax base. Purchases of goods for resale (i.e. sales for resale) are not taxed. Also untaxed are materials used as components in manufactured products or used in the production process.

Some items are excluded from the general sales tax base because they are already taxed under a separate state sales, excise or severance tax. The major items excluded from the sales tax for this reason are motor vehicles, motor fuels, crude oil, mixed alcoholic drinks, cement and sulphur.

In the case of motor fuels and mixed drinks, the separate tax is higher than the sales tax. Crude oil, cement and sulphur are taxed under separate statutes at lower effective tax rates.

Purchasers of cars and trucks are exempted from the general sales tax because they are under a separate motor vehicle tax.

Major exceptions to the general rule of avoiding double taxation are items taxed under the so-called "sin" taxes. Alcoholic beverages sold at stores, cigarettes and other tobacco products are subject to separate excise taxes in addition to the sales tax.

Sales tax discounts

Texas' sales tax law allows two kinds of discounts.

Taxpayers who report and remit on time

may keep 0.5 percent of the tax they collect. In 1997, this timely filing discount will cost the state an estimated $47.7 million.

Taxpayers who prepay their taxes based on a reasonable estimate of their tax liability may keep an additional 1.25 percent as reward for early payment. The cost of this prepayment discount will be about $30.3 million in fiscal 1997. ✪

Estimated cost of sales tax exclusions other than services

Millions of dollars

Items taxed under other laws

Item	1996 revenue	Value of sales tax exclusion[1]
Crude oil	$ 377.0	$ 0
Motor vehicles	1,965.3	1,661.8
Motor fuels	2,321.0	748.5
Mixed drinks	272.7	121.8
Cement	5.6	0
Sulphur	3.2	0
Subtotal		$2,532.1
Materials used in manufacturing	n/a	6,007.4
Total		**$8,539.5**

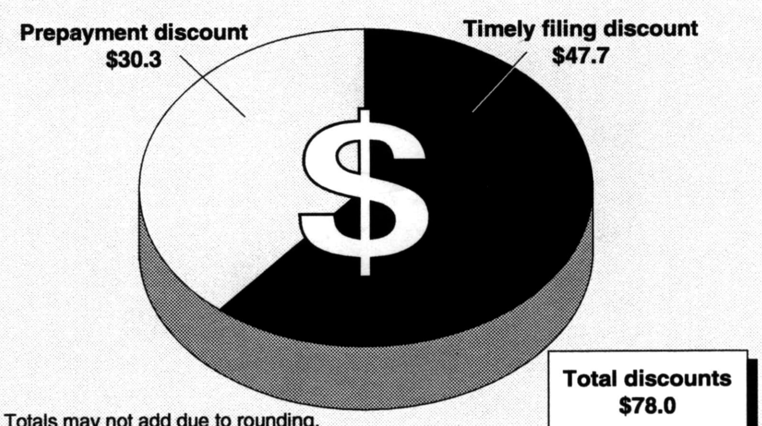
[1] Even with exclusion due to taxation under other law, crude oil, cement, and sulphur would not be subject to sales tax liability because these items would qualify for exclusion as materials used in manufacturing. The value of the sales tax exclusions are estimated based upon the current sales tax rate of 6.25 percent.

Totals may not add due to rounding.

SOURCE: John Sharp, Texas Comptroller of Public Accounts.

Sales tax discounts, fiscal 1997

Millions of dollars



Totals may not add due to rounding.

SOURCE: John Sharp, Texas Comptroller of Public Accounts.

Franchise Tax

Adopted in 1907, the franchise tax is one of Texas' oldest revenue sources. Corporations, including IRS subchapter S corporations, and limited liability companies doing business in Texas pay the tax. Non-corporate business entities such as partnerships, associations and proprietorships are not subject to the tax.

The franchise tax is privilege tax, meaning that corporations pay the tax in exchange for specific privileges granted by the State of Texas. These privileges include access to the state's legal system, treatment as a legal "person," and limitation of personal financial liability for officers of the corporation.

Tax payments and tax reports are due annually to the Comptroller of Public Accounts on May 15. The tax report should cover business done during the firm's accounting year that ended in the prior calendar year. The law provides for a report extension to November 15 if the taxpayer remits payment by May 15. The tax privilege year is the calendar year containing the payment due date.

Franchise tax gross collections have risen steadily in the past several years, totalling $1,818 million in 1996, $1,632 million in 1995 and $1,479 million in 1994. Net collections after refunds have also grown respectably, summing to $1,261, $1,425, and $1,642 million in years 1994-96, respectively.

In 1995, the last complete year of reporting, about 341,000 firms were subject to the tax. More than one-half of these firms had no tax liability. A relatively small number of large firms pay the bulk of the total tax burden. The top 10 percent of taxpaying firms pay about 90 percent of the total tax levy.

How the franchise tax is computed

Corporations make two sets of tax calculations: one for their "net worth" (or taxable capital) tax base, and another for their "earned surplus" tax base. The results are then used to determine final tax liability.

The "net worth" tax base is computed by summing the corporation's stated capital and surplus. Stated capital is the par value of the firm's outstanding shares of stock. Surplus is the remainder of the firm's net worth. Net worth is defined as the firm's total assets minus debts. For franchise tax purposes, debts are time-certain, date-certain and legally enforceable.

Firms apportion their total net worth tax

Cost of franchise tax exemptions for profit-making corporations, fiscal year 1997

Millions of dollars

Exemptions	Amount
Insurance companies	$103.6
Open-end investment companies (mutual funds)	80.9
Title insurance companies	2.0
Solar energy businesses	0.3
Trade show participants	***
Title-holding companies	***
Farm finance companies	***
Sludge recycling firms	***
Subtotal	$186.8
Deductions	
Interest earnings on federal securities	$ 36.5
Officer/director compensation add-back exemption for 35-or-less-shareholder corporations	111.0
Food and medicine receipts	0.6
Business loss carryover	202.5
Investment in enterprise zones	10.0
Purchase of solar energy devices	***
Firms with tax liability of less than $100	1.8
Subtotal	$362.4
Special Accounting	
Exemption from GAAP accounting methods for corporations with less than $1 million in taxable capital	$ 8.6
Regulated investment company special apportionment method	3.7
Transportation company special apportionment method	4.7
Telephone company special apportionment method	1.2
Subtotal	$ 18.2
Credits	
Temporary (FAS 96) credit	$ 2.9
Subtotal	$ 2.9
TOTAL COST	**$570.3**

*** These items have a negligible cost to the state.

SOURCE: John Sharp, Texas Comptroller of Public Accounts.

base to Texas according to the share of their total business done in the state, measured in terms of their gross receipts. A tax rate of 0.25 percent is applied to the apportioned tax base to determine the tax on taxable capital.

The "earned surplus" tax base is calculated by summing the firm's federal taxable income and the firm's compensation paid to officers and directors. Deductions are allowed for certain foreign income and dividends received. Small corporations (i.e., those with 35 or fewer shareholders) are permitted to exclude officer and director compensation from their tax base.

Firms also apportion their earned surplus tax base to Texas according to the share of their business done in the state, measured in terms of their gross receipts. A Texas business loss carryover may be used to reduce apportioned earned surplus. The tax rate on earned surplus is 4.5 percent.

Technically, a corporation first calculates its tax liability on its net worth base. If the tax on earned surplus exceeds the tax on net worth, the corporation must also pay a surtax on its earned surplus. The surtax is equal to the firm's earned surplus tax liability minus its net worth tax liability. In practice, the firm simply pays the higher of the tax on net worth or the tax on earned surplus.

Franchise tax adjustments

The franchise tax code contains a number of provisions that allow firms to reduce their tax liability. These include exemptions, deductions, special accounting rules and credits.

Exemptions An exemption is used to grant certain types of firms a full waiver from all franchise tax liability and reporting. For example, insurance companies are granted a full exemption because they are required to submit financial reports to the Department of Insurance and to pay a separate tax on their gross premiums.

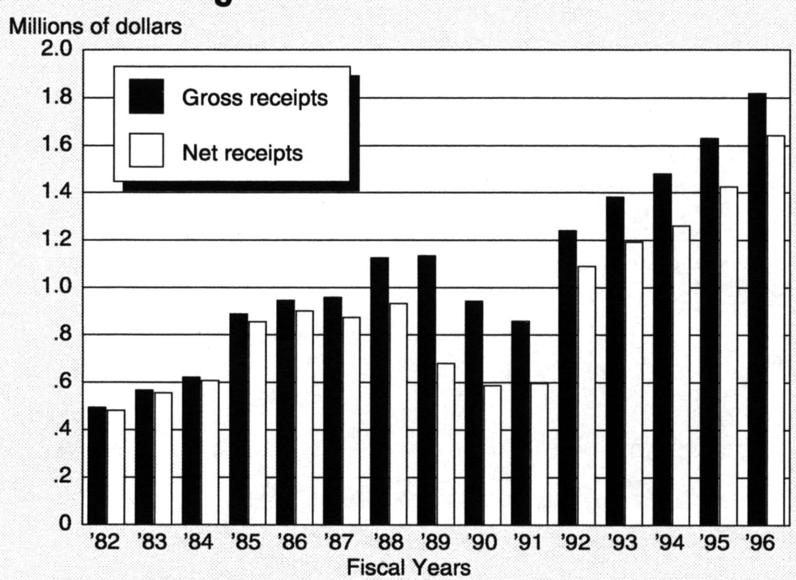
Deductions and exclusions A tax deduction or exclusion grants an otherwise taxable firm a variance from a particular requirement of the franchise tax law. Generally, all other franchise tax regulations must be followed.

One reason for granting special deductions or exclusions is to promote certain activities or behavior. For example, to encourage the development of solar energy sources, the Legislature has permitted firms to exclude from their tax base their purchases of qualifying solar energy devices.

Some deductions or exclusions may be granted to prevent the taxation of items exempt from taxation under federal law, such as interest income on U.S. Treasury securities. Other deductions or exclusions grant tax relief to small firms, such as the provision that allows small corporations to exclude executive compensation from their earned surplus tax base.

Special accounting rules A special accounting rule allows a qualifying firm to use an accounting or apportionment method not available to all other franchise taxpayers. The special accounting may be designed to relieve small firms of certain accounting burdens. Also, in the same manner as a deduction or exclusion, a special accounting may be used to encourage certain activities. For example, regulated investment companies benefit from a special apportionment rule

Franchise tax gross and net collections



SOURCE: John Sharp, Texas Comptroller of Public Accounts.

because the Legislature sought to encourage these firms to locate in Texas.

Credits Tax credits come in two types, distinguished by their frequency. One-time credits are available for a single tax period (or until they are used up). In contrast, continuing credits are available for use year after year. Each type can be used for a variety of purposes, e.g., to influence taxpayer behavior, to grant tax relief, or to smooth the flow of state and local tax receipts.

Special rates A special rate usually takes the form of a lower tax rate. HB 11 (First Called Session, 72nd Legislature) repealed the last remaining special rate provision in the franchise tax code.

Specific Provisions

The franchise tax code distinguishes between two broad categories of firms: profit-making entities and non-profit entities. Profit-making entities can qualify for several different types of special treatment, including outright exemption. The provisions affecting nonprofit entities generally remove qualifying firms from all tax liability and all normal reporting requirements as long as the firms maintain their nonprofit status.

Profit-making corporation: The total value of all exemptions, deductions and other forms of special treatment granted to profit-making firms will be $570.3 million for fiscal year 1997. Full exemptions will account for $186.8 million, while deductions and exclusions will amount to $362.4 million. Special accounting rules will account for $18.2 million, and credits will total $2.9 million. All special rate provisions have been repealed.

Exemptions The law exempts eight types of profit-making corporation from the franchise tax. These include insurance companies, open-end investment companies, title insurance holding companies, solar energy businesses, certain trade show participants, corporations that hold title to property for

Cost of franchise tax exemptions for exempt nonprofit corporations, fiscal 1997

Millions of dollars

Organization Type	Examples	Cost
Religious, educational and charitable	Universities, hospitals, Red Cross, United Way	$111.2
Civic and social welfare	Lions Clubs, Rotary Clubs, volunteer fire departments	4.4
Labor and agricultural	United Auto Workers, ML Baseball Players Association	3.6
Business development and promotion	Chambers of Commerce, American Bar Association	4.9
Social and recreational	Fraternities, sororities, yacht clubs, country clubs	1.1
Other	Mutual and cooperative organizations, credit unions, cemeteries	5.2
TOTAL		**$130.4**

Note: Estimated exemption costs do not include religious organizations.

SOURCE: John Sharp, Texas Comptroller of Public Accounts.

an exempt organization, farm finance corporations and firms engaged in sludge recycling.

The largest exemption goes to open-end investment companies (money-market and mutual funds) which have enjoyed an exempt status under the franchise tax since 1951. This exemption will be worth $80.9 million to the 61 qualifying firms in 1997.

The more than 2,000 insurance companies that pay the gross premiums tax. will receive an exemption worth $103.6 million in 1997. This exemption was written into the original franchise tax statute, enacted in 1907. In 1996, Texas collected $627 million in insurance premium taxes.

Title insurance companies hold the third largest exemption, valued at $2.0 million for 1997. This exemption, which the Legislature placed in the Insurance Code in 1989, is applicable for more than 500 title insurers.

Companies whose only business is to make, sell or install solar energy devices are also exempt from the franchise tax. The Legislature added this exemption in 1975 to encourage development of alternative energy sources. Seventy-eight firms have qualified for this exemption, representing a total value of $0.3 million in 1997.

Four types of available exemptions will produce negligible revenue effects for fiscal year 1997. First, corporations whose business in Texas is limited to participation in five or fewer trade shows in the state per year are exempt. Five firms have qualified for this exemption. Second, legislation enacted in 1987 exempted corporations that hold title to property for an exempt organization. The third category was adopted in 1991 and exempts corporations organized to finance farm crop operations. The fourth category, adopted in 1989, exempts firms exclusively engaged in the recycling of sludge.

Savings and loan associations were exempt under the franchise tax from 1949 through 1991. HB 11 repealed this exemption.

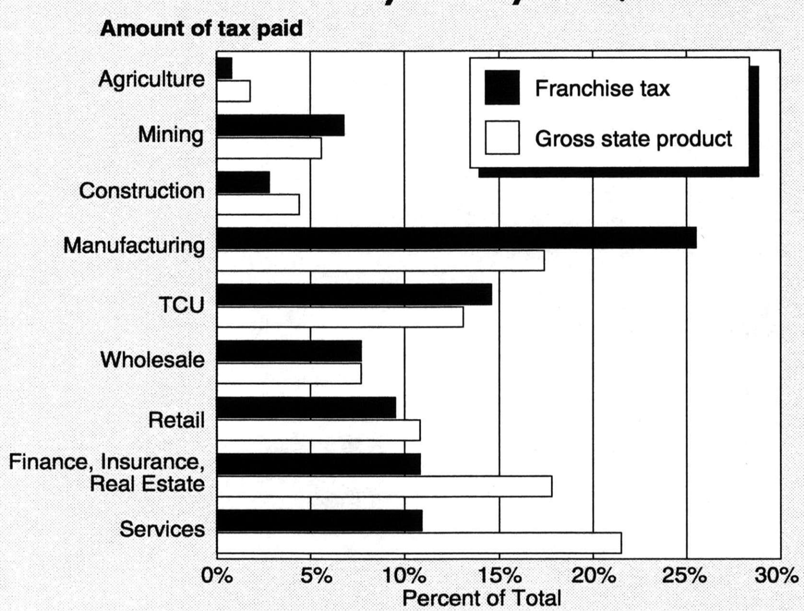
Deductions and exclusions Two special deductions may be taken from a firm's earned surplus tax base prior to apportionment. First, firms are permitted to deduct interest income from U.S. securities, which are exempt from taxation by federal law. Second, the required add-back for officer and director compensation is waived for firms with 35 or fewer shareholders. The interest exclusion will have a value of $36.5 million in 1997, while the small corporation officer compensation waiver will be worth $111.0 million.

For purposes of apportioning taxable capital, firms may also deduct from their Texas receipts their receipts for shipments into Texas of tax-exempt food and health-care supplies. The deduction cannot be used for apportioning earned surplus. The value of this deduction will be worth 0.6 million in 1997.

Three other deductions can be taken in computing a firm's apportioned tax bases. The first permits firms to deduct from their earned surplus tax base any accumulated earned surplus business losses. The business loss carryover deduction will have a value of $202.5 million in 1997. This deduction was added by HB 11 in 1991.

The second deduction permits the reduction of either taxable capital or earned sur-

Gross state product, employment and franchise tax collections by industry share, fiscal 1995



SOURCE: John Sharp, Texas Comptroller of Public Accounts.

plus by the amount of the firm's investment in an enterprise zone. Enterprise zone investment in 1990-91 may be deducted beginning in 1992, investment in 1992-93 may be deducted starting in 1994, and investment in 1994-95 may be deducted starting in 1996. The enterprise zone deduction will have a value of $10.0 million in 1997.

The third deduction permits the deduction of the cost of solar energy equipment from either the taxable capital base or the earned surplus base (but not both). This exemption will have a negligible value in 1997.

Finally, firms with a tax liability of less than $100 are not required to remit the tax, although they must follow other franchise tax regulations. The value of this exclusion will be $1.8 million in 1997.

Special accounting Most corporations are required to follow generally accepted accounting procedures (GAAP) in computing the tax on taxable capital. This requirement is waived in three cases. Firms organized as either Subchapter S corporations or close corporations and corporations with less than $1 million in taxable capital, regardless of their organization, are allowed to use federal income tax (FIT) accounting rules. Use of FIT accounting rules generally results in the reduction of tax liability. The value of the FIT accounting provision will be $8.6 million in 1997.

Most firms that provide services (as opposed to tangible goods) are required to source their receipts to the location where the service was performed. A special statutory apportionment formula sources receipts from regulated investment company management services to the domicile of the owners of the investment funds. In 1997, this special accounting rule will cost the state $3.7 million.

Both transportation companies and telephone companies are allowed to exclude from their Texas receipts the Texas share of receipts from interstate commerce. Telephone companies include in their Texas receipts the receipts from phone calls that begin and end in Texas but exclude receipts from phone calls that cross state lines. Even though the telephone service is to some extent delivered in Texas, the state collects no revenue on that phone call. Transportation companies follow similar rules. The cost to the state in 1997 of these special apportionment rules are $1.2 million for telephone companies and $4.7 million for transportation companies.

Alternative apportionment formulas, such as two- and three-factor methods, were available to some multi-state corporations until 1989. These methods allowed firms to lower their tax bill by using additional factors (property and payroll) to allocate their tax base to the state. In 1989, the Legislature repealed their use.

Credits The franchise tax currently provides for a continuing credit and a one-time credit.

The continuing credit allows corporations to minimize the accounting burdens of Financial Accounting Standard 96 (FAS 96). Taxpayers are permitted to deduct, over a 20-year period, the amount of the timing differences on their books at their fiscal year-end when the HB 11 franchise tax provisions became effective. Timing differences are created by the differences between accounting requirements of federal income tax and financial reporting. Taxpayers electing the FAS 96 credit are required to pay an additional 0.2 percent tax on their taxable capital. The value of this credit will be $2.9 million in 1997.

The one-time credit related to the payment of sales tax on manufacturing machinery and equipment purchased between October 1991 and September 1993 remains available through fiscal 1999, although the credit has been virtually exhausted and will have no anticipated fiscal cost in 1997.

Special Rates Special tax rates (one-fifth the normal rate) were available to certain utility holding companies and transportation companies until the Legislature repealed these provisions for tax years after 1991.

Nonprofit Corporations: Lack of information makes it difficult to estimate the net worth of nonprofit corporations in Texas. Churches are exempt from all financial filing laws, and other nonprofit firms are not required to report their financial condition. Estimates of the value of the nonprofit exemptions are based on federal data.

As the name would suggest, nonprofit corporations have virtually no profits (and thus virtually no earned surplus). The value of the exemption is primarily based on the value of these firms' net worth. Excluding churches, the total exemption for nonprofit corporations will be worth $130.4 million in 1997.

Religious, educational and charitable organizations include churches, charities, schools, amateur sports associations and universities. Excluding churches, the exemption for these groups will be worth $111.2 million in 1997.

Civic and social welfare organizations include many familiar clubs and organizations, e.g., the Lions Club, Rotary Clubs and volunteer fire departments, among others. This exemption will total $4.4 million in 1997.

Labor union and agricultural group exemptions will be worth $3.6 million; and the exemption for business development and promotion groups (e.g., chambers of commerce and development societies) will be worth $4.9 million.

Social and recreational groups, consisting of fraternities, sororities and country clubs, will have an exemption value of $1.1 million in 1997. The exemption of other nonprofit corporations, including cooperative organizations (primarily electric and telephone cooperatives), cemetery companies and credit unions will have a value of $5.2 million in 1997.

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