SPECIAL FINANCIAL REPORT

JOHN SHARP
Texas Comptroller
of Public Accounts

January 1993

A report to the Governor and Texas Legislature

Sales and Franchise Tax Exemptions

In fiscal 1993—the year between September 1, 1992, and August 31, 1993—sales and franchise tax exemptions will amount to a total of $12.7 billion.

Sales tax exemptions will total $12.4 billion. Franchise tax exemptions will total $341 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 $2.0 billion in 1993.

Franchise tax exemptions go to both profit-making and nonprofit businesses. In 1993 these will total $273 million and $68 million, respectively.

At $8.5 billion, the sales tax was the state's biggest single source of tax revenue in the 1992 fiscal year. Franchise tax ranked fourth, with net receipts of $1.1 billion from corporations doing business in Texas. Together, sales and franchise taxes accounted for 61 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.

Continued on page 3

A Message From John Sharp

January 11, 1993

The Honorable Ann W. Richards

Ladies and Gentlemen

In fiscal 1993 sales and franchise tax exemptions will total an estimate $12.7 billion. Of this total, sales tax exemptions will account for $12.4 billion, and franchise tax exemptions will account for $341 million.

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.

There are no recommendations for retaining, eliminating or amending any provisions of these laws in this report.

Respectfully,

JOHN SHARP
Texas Comptroller of Public Accounts

Sales Tax

The limited sales and use tax

The sales tax is the largest source of revenue for Texas state government, bringing in about 54 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 topped $8.5 billion in fiscal 1992, 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 $52.9 million in 1993). Others affect specific industries.

Estimated cost of sales and franchise tax exemptions, exclusions and discounts, fiscal 1993

Millions of dollars

Sales Tax	
Amount	
Exemptions	$ 2,754.6
Services exclusions	2,014.4
Other exclusions	7,544.1
Discounts	63.0
Total, sales tax	12,376.2
Franchise Tax	
Profit-making corporations:	
Exemptions	105.5
Special rates	0.0
Deductions	148.6
Special accounting	8.1
Credits	11.0
Nonprofit corporations	67.6
Total, franchise tax	340.8
TOTAL	**$12,717.0**

Totals may not add due to rounding.

SOURCE: John Sharp, Comptroller of Public Accounts.

Agriculture receives exemptions for machinery and equipment, livestock, feed, seed, fertilizer, pesticides, gas and electricity and certain containers. These agricultural exemptions will be worth a total $300.8 million in fiscal 1993.

Oil and gas exploration and production businesses receive exemptions for gas and electric power ($39.3 million) and drilling equipment used offshore ($18.9 million).

Contractors who work on projects for school districts or non-profit hospitals may purchase their equipment for those projects tax-free ($5.4 million).

The vending machine industry receives an exemption for receipts from coin-operated amusement machines worth $24.6 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 ($5.1 million in 1993). 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 $6.7 million in fiscal 1992—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 ($76.2 million) and repair equipment ($9.4 million) tax-free. Certain commercial ships, parts and repair remain untaxed ($20.3 million). And railroads pay no sales tax on the purchase of locomotives and rail cars ($1.2 million), or on fuel, parts and supplies ($7.4 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 ($371.6 million) and wrapping and packaging materials ($71.0 million) used in manufacturing are exempt.

The sales tax on purchases of manufacturing machinery and equipment is currently being phased out. Under the phaseout schedule, manufacturers who purchased qualifying machinery and equipment between January 1, 1990, and September 30, 1991, have applied directly to the Comptroller's office for a 25 percent refund of sales tax paid. Refunds are being paid on these claims and are estimated to total $40.1 million in fiscal 1993.

A change in the law adopted during the last legislative session allows a partial exemption for purchases made between October 1, 1991, and September 30, 1993, but the reduction will be a credit applied to a taxpayer's franchise tax bill —not a refund.

Major sales tax exemptions and exclusions, fiscal 1992

	Number of states exempting[1]	Exempt in Texas?
Consumer goods		
Groceries	25	yes
Prescription drugs	44	yes
Motor fuels	36	yes[2]
Alcoholic beverages	0	no[2]
Services		
Residential gas and electricity	20	yes
Water		
Industrial	25	yes
Residential	34	yes
Telecommunication services	8	no
Laundry and dry cleaning	27	no[3]
Barber and beauty services	41	yes
Amusement services	13	no
Management consulting and public relations	39	yes
Legal services	41	yes
Accounting and audit services	41	yes
Architectural services	40	yes
Engineering	42	yes
Financial securities brokerage	44	yes
Real estate brokerage and agency	41	yes
Automotive maintenance and repair	25	yes[4]
Agricultural goods		
Feed, seed, fertilizer, etc.	45	yes
Agricultural machinery	30	yes
Business goods		
Sales for resale	44	yes
Production machinery	27	no[5]
Materials used in processing	45	yes

1 Forty-five states imposed a general sales tax.
2 Motor fuels are taxed under the motor fuels tax. Texas exempts mixed drinks which are taxed under the mixed beverage tax.
3 Coin-operated laundry services remain exempt.
4 Parts are taxable. Labor is exempt.
5 Sales tax on production machinery and equipment is currently being phased out.

SOURCES: State Tax Guide-All States and State Tax Review (Commerce Clearing House, various issues); Federation of Tax Administrators, Sales Taxation of Services, Who Taxes What?, April 1991; Phone survey, Revenue Estimating Division.

Beginning on October 1, 1993, qualifying purchases of manufacturing machinery and equipment will be subject to a 50 percent reduction in sales tax. Sales tax reductions of 75 percent will follow starting January 1, 1994. Eligible purchases made on or after January 1, 1995, will be entirely exempt from sales tax. The exemption for manufacturing machinery will cost the state about $550 million annually once fully in place. Supporters of this exemption say it will put the state on more even footing with other major industrial states.

Services exclusions

For most of its history, the sales tax was not imposed on sales of services. But in the last eight years, more 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.

In fiscal 1993, sales tax collections will be over 9 percent higher due to the cumulative gains from services taxation since 1984.

Even so, many services remain excluded from tax. Total service exclusions will be worth about $2.0 billion in fiscal 1993, 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 ($531.4 million), legal services ($200.1 million), accounting and audit services ($86.1 million), engineering and architectural services

Estimated cost of sales tax exemptions and exclusions, fiscal 1993[1]

Millions of dollars

Item	Amount
Food for home consumption	$ 779.7
Manufacturing gas and electricity	371.6
Residential gas and electricity	435.0
Property used for the improvement of exempt realty	5.4[2]
Agricultural feed, seed, chemicals and supplies	157.5
Sales to governmental entities	150.3
Prescription medicine and devices	126.2
Livestock for food	80.1
Water	132.8
Manufacturing machinery and equipment	40.1[3]
Packaging and wrapping supplies	71.0
Aviation fuel	76.2
Agricultural manufacturing machine and equipment	43.0
School lunches and certain food sales	42.3
Containers	52.9
Certain drilling equipment	18.9
Coin-operated amusements	24.6[4]
Certain ships	20.3
Agricultural gas and electricity	12.4
Newspaper inserts	13.1
Magazine subscriptions	10.8
Repair equipment for certain aircraft	9.4
Sales to non-profits	10.2
Railroad fuel and supplies	7.4
Newspapers	8.7
Horses, mules and work animals	7.5
One day sales	2.3
Religious writings	2.1
Mining gas and electricity	39.3
Rolling stock and locomotives	1.2
Commercial fishing ice	0.7
Equipment used in enterprise projects	1.4
Agricultural containers	0.3
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	**$2,754.6**

[1] Estimates assume a tax rate of 6.25 percent and are for the full twelve months of fiscal 1993.
[2] Only applies to construction equipment purchased for use in jobs for school districts and non-profit hospitals.
[3] Represents refunds for purchases made during 1990 and 1991. Estimated cost of exemption during the 1994-95 biennium is $775 million.
[4] 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, Comptroller of Public Accounts.

($99.4 million), real estate brokerage ($78.6 million), financial securities brokerage ($52.8 million) and veterinary services ($25.6 million).

Labor charges by contractors on new residential and nonresidential construction jobs are not taxable ($159.8 million). And labor for residential repair and remodeling is still tax-free ($42.0 million).

Other business services that are not taxed include advertising ($116.4 million); contract computer programming ($32.2 million); management consulting and public relations ($42.6 million); employment agency, temporary labor supply and other personnel services ($50.8 million) and intrastate freight hauling ($166.9 million).

Personal services not taxed include beauty and barber service ($30.0 million), funeral services ($22.9 million), child day care ($34.3 million) and coin-operated laundry ($5.8 million).

Automotive maintenance and repair ($90.9 million), car washing ($9.2 million) and travel arrangement services ($24.6 million) remain tax-free. Other untaxed services include certain educational services ($13.3 million) and interior design ($3.6 million).

Estimated cost of services excluded from the sales tax base, fiscal 1993[1]
Millions of dollars

Item	Amount
Construction labor	
New residential construction	$ 66.9
New non-residential construction	92.9
Residential repair and remodeling	42.0
Personal services	
Barber and beauty services	30.0
Funeral services	22.9
Coin-operated laundry	5.8
Child day care	34.3
Miscellaneous personal services	3.9
Business and professional services	
Physicians services	320.4
Dental services	90.1
Other health care	120.9
Legal services	200.1
Accounting and audit services	86.1
Architectural and engineering services	99.4
Management consulting and public relations	42.6
Contract computer programming	32.2
Research and development laboratory services	8.5
Economic and sociological research	11.7
Testing labs	15.9
Advertising media	116.4
Film production	3.0
Employment agency services	16.7
Temporary labor supply	34.1
Financial services brokerage	52.8
Other financial services	44.7
Real estate brokerage and agency	78.6
Freight hauling	166.9
Other transportation (except scheduled passenger)	7.1
Veterinary services	25.6
Other services	
Automotive maintenance and repair	90.9
Car washes	9.2
Travel arrangement	24.6
Private vocational education	8.8
Other educational services	4.5
Interior design	3.6
TOTAL–SERVICES EXCLUDED	**$2,014.4**

1 Estimates assume a tax rate of 6.25 percent and are for the full twelve months of fiscal 1993. Totals may not add due to rounding.

SOURCE: John Sharp, Comptroller of Public Accounts.

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 1993, this timely filing discount will cost the state an estimated $38.6 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 $24.5 million in fiscal 1993.

Estimated cost of sales tax exclusions other than services

Millions of dollars

Items taxed under other laws

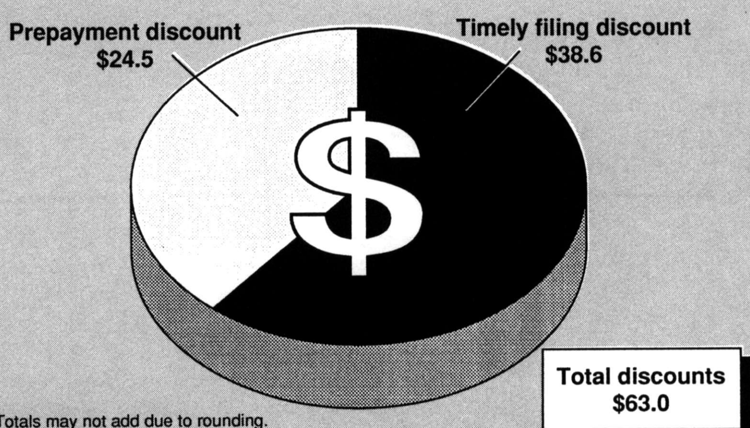
Item	1992 revenue	Value of sales tax exclusion[1]
Crude oil	$ 512.7	$ 0
Motor vehicles	1,215.3	1,190.1
Motor fuels	1,953.5	650.4
Mixed drinks	245.2	109.1
Cement	4.0	0
Sulphur	3.9	0
Subtotals	$3,934.6	$1,949.6
Materials used in manufacturing	n/a	5,594.5
TOTAL		**$7,544.1**

[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.

SOURCE: John Sharp, Comptroller of Public Accounts.

Sales tax discounts, fiscal 1993

Millions of dollars



Totals may not add due to rounding.

SOURCE: John Sharp, Comptroller of Public Accounts.

Franchise Tax

Adopted in 1907, the corporate franchise tax is one of Texas' oldest revenue sources. The tax applies to corporations doing business in Texas. Non-corporate business entities, such as partnerships, associations and proprietorships, are not subject to the tax.

The franchise tax is considered a 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," immunity from personal financial liability for officers of the corporation and other rights.

In 1991, the state Legislature enacted House Bill 11 (First Called Session, 72nd Legislature), which instituted several fundamental changes in the franchise tax code. These included the redefinition of the tax base, the elimination of some exemptions and special rates and a substantial reduction in the number of firms with a tax liability.

As a result of the changes enacted in HB 11, franchise tax gross collections jumped from $822 million in fiscal year 1991 to $1,240 million in fiscal year 1992. During the same period, the tax's net contribution (after refunds) to total state tax collections rose from 4.0 percent to 6.9 percent.

In addition to increasing tax revenues, HB 11 produced a slight redistribution in the tax burden among firms. The general effect has been to shift the tax from capital-intensive firms (e.g., oil and gas and manufacturing) towards high-margin firms (e.g., high-tech business services). Consequently, the share of franchise tax collections paid by each industry now more closely mirrors that industry's contribution to the state's economy.

Despite the changes in the tax base brought by HB 11, a relatively small number of large firms continue to bear a disproportionate share of the tax burden. The top 10 percent of taxpaying firms pay almost 88 percent of the total tax levy.

Although the number of incorporated businesses in Texas has increased slightly, the number of firms with a tax liability has dropped. Due to a provision in HB 11, if a firm's tax liability falls below $100, no tax is due. In 1991, almost 284,000 corporations (including banks) paid the tax. In 1992, there were 292,000 firms subject to tax, but only 151,000 of those firms paid the tax; the remaining 141,000 taxpayers owed no tax.

Cost of franchise tax exemptions for profit-making corporations, fiscal 1993
Millions of dollars

Exemptions	Amount
Insurance companies	$87.3
Open-end investment companies	13.2
Title insurance companies	4.3
Savings and loan institutions	repealed
Solar energy businesses	0.7
Trade show participants	negligible
Title-holding companies	negligible
Farm finance companies	negligible
Sludge recycling firms	negligible
Subtotal	$105.5
Special rates	
One-fifth rate	repealed
Subtotal	$0.0
Deductions	
Firms with tax liability of less than $100	1.4
Executive compensation add-back	42.7
Food and medicine sales	negligible
Purchases of solar energy devices	negligible
Investment in enterprise zones	4.9
Business loss carryover	50.1
Interest earnings on federal securities	49.5
Subtotal	$148.6
Special Accounting	
FIT accounting for taxable capital	8.1
Regulated investment company	negligible
Two and three-factor allocation rates	repealed
Subtotal	$8.1
Credits	
One-time credits:	
Sales tax on manufacturing equipment	0.0
Bank credits	7.8
Continuing credits:	
Temporary (FAS 96) credit	3.2
Subtotal	$11.0
TOTAL	**$273.2**

SOURCE: John Sharp, Comptroller of Public Accounts.

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.

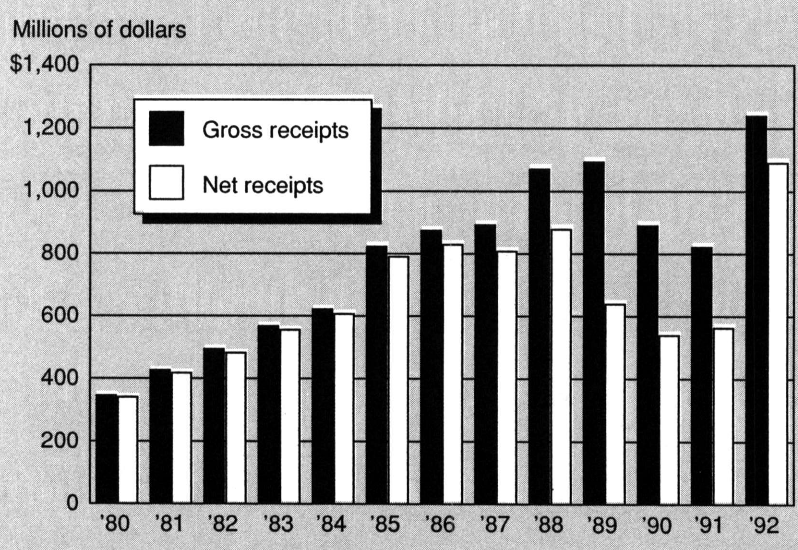
Firms apportion their net worth tax base to Texas according to the share of their business that occurred in the state, measured in terms of their gross receipts. A tax rate of 0.25 percent is applied to determine the tax on taxable capital.

The "earned surplus" tax base is calculated by adding the compensation paid to officers and directors to the firm's federal taxable income. 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 that occurred 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 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 gross and net collections



SOURCE: John Sharp, Comptroller of Public Accounts.

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 and to pay a tax on their gross premiums to the Department of Insurance.

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 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 and to smooth the flow of state and local tax receipts. The largest credit is granted for sales taxes paid on manufacturing machinery and equipment.

Special rates A special rate usually takes the form of a lower tax rate. HB 11 repealed the last remaining special rate provision in the franchise tax code.

Specific Provisions

The corporate 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 corporations The total value of all exemptions, deductions and other forms of special treatment granted to profit-making firms will be $273.2 million for fiscal year 1993. Full exemptions will account for $105.5 million, while deductions and exclusions will amount to $148.6 million. Special accounting rules will account for $8.1 million, and credits will total $11.0 million. All special rate provisions have been repealed.

Exemptions The law exempts eight types of profit-making corporations 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 an exempt organization, farm finance corporations and firms engaged in sludge recycling.

The largest exemption—$87.3 million in 1993—goes to the more than 2,000 insurance companies that pay the gross premiums tax. This exemption was written into the original franchise tax statute, enacted in 1907. In 1992, Texas collected $471 million in insurance premium taxes.

Open-end investment companies (money-market and mutual funds) have enjoyed an exempt status under the franchise tax since 1951. The exemption granted to the 53 firms that qualify for it will be worth $13.2 million in 1993.

Title insurance companies hold the third largest exemption, valued at $4.3 million for

Cost of franchise tax exemptions for exempt nonprofit corporations, fiscal 1993
Millions of dollars

Exemptions	Amount
Religious, educational and charitable	$38.9
Civic and social welfare	1.2
Labor and agricultural	0.3
Business development and promotion	2.2
Social and recreational	1.6
Fraternal benefit societies	negligible
Mutual or cooperative organization	20.0
Cemetary companies	3.1
Credit Unions	0.3
Farm marketing cooperatives	negligible
TOTAL	**$67.6**

SOURCE: John Sharp, Comptroller of Public Accounts.

1993. This exemption, which the Legislature placed in the Insurance Code in 1989, is applicable for more than 500 title insurers.

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

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. Eighty-one firms have qualified for this exemption, representing a total value of $0.7 million in 1993.

Four types of available exemptions will produce negligible revenue effects for fiscal year 1993. 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.

Deductions and exclusions Three deductions can be taken in computing a firm's apportioned tax bases. The first 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 1993.

The second deduction permits the reduction of either taxable capital or earned surplus by the amount of the firm's investment in an enterprise zone. Enterprise zone investment in 1990-91 may be deducted beginning in 1992, and investment in 1992-93 may be deducted starting in 1994. The enterprise zone deduction will have a value of $4.9 million in 1993.

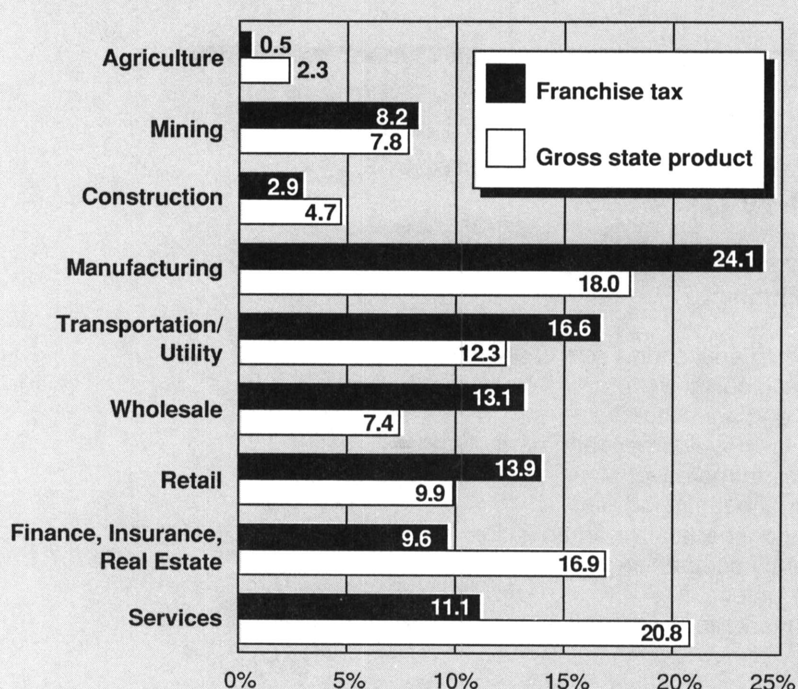
The third deduction permits firms to deduct from their earned surplus tax base any accumulated earned surplus business losses. The business loss carryover deduction will have a value of $50.1 million in 1993. This deduction was added by HB 11 in 1991.

Two other deductions may be taken from the 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 $49.5 million in 1993, while the small corporation compensation waiver will be worth $42.7 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 negligible in 1993.

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 $1.4 million in 1993.

Franchise tax and gross state product by industry, fiscal 1992



SOURCE: John Sharp, Comptroller of Public Accounts.

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 $8.1 million in 1993.

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 1993, this special accounting rule will have a negligible value.

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 provides for two separate one-time credits and one continuing credit.

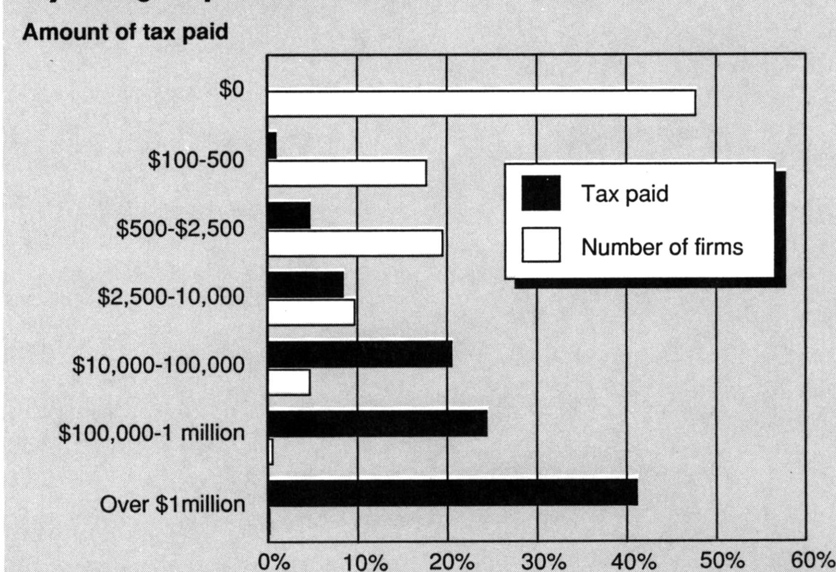
A one-time credit for sales tax paid on manufacturing machinery and equipment allows corporations to receive a credit for sales tax paid on those items purchased between October 1, 1991 and September 30, 1993. The credit is 25 percent of the sales tax paid between October 1, 1991 and December 31, 1992, and 50 percent of the sales tax paid between January 1, 1993 and September 30, 1993. The credit may be taken starting with the 1994 franchise tax report. Although the value of the credit will be zero in 1993, it is expected to be worth $318 million in 1994. This credit is the result of 1991 legislation that delayed the staged exemption for sales tax on manufacturing machinery and equipment.

Another one-time credit allows banks to take a tax credit for a portion of their verified over-payments resulting from court-ordered refunds due to legal challenges to the tax base. Banks were authorized credits starting in 1990 in order to smooth the stream of funds allocated to local governments by the bank franchise tax. The state assumed responsibility for these refunds with the adoption of HB 11. This credit will be worth $7.8 million in 1993. A carryover of about the same amount should occur in 1994, after which time these credits should be exhausted.

The only continuing credit in the franchise tax code 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 the 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 $3.2 million in 1993.

Special Rates Special tax rates (one-fifth the

Percent tax paid and number of taxpayers by tax group, fiscal 1992



SOURCE: John Sharp, Comptroller of Public Accounts.

normal rate) were available to certain utility holding companies and transportation companies until the Legislature repealed these provisions in 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 $67.6 million in 1993.

Religious, educational and charitable organizations include churches, charities, schools, amateur sports associations and universities. Excluding churches, the exemption for these groups will be worth $38.9 million in 1993.

Civic and social welfare organizations include many familiar clubs and organizations, e.g., the Moose, the Odd Fellows and the Lions, among others. This exemption will total $1.2 million in 1993.

Labor union and agricultural group exemptions will be worth $0.3 million; the exemption for business development and promotion groups (e.g., chambers of commerce and development societies) will be worth $2.2 million.

Social and recreational groups, consisting of fraternities, sororities and country clubs, will have an exemption value of $1.6 million in 1993. Cooperative organizations (primarily electric and telephone cooperatives) will have an exemption value of $20.0 million in 1993.

The exemption for cemetery companies will have a value of $3.1, and the exemption for credit unions will have a value of $0.3 million in 1993.

The exemptions for fraternal benefit societies and farm marketing cooperatives will have a negligible revenue value.

Material in *Special Financial Reports* is not copyrighted and may be reproduced. The Comptroller of Public Accounts would appreciate credit for the material used and a copy of the reprint. For additional copies or back issues, or to become a subscriber, write:

Special Financial Reports
John Sharp, Texas State Comptroller
P.O. Box 13528
Austin, TX 78711-3528

or call 463-4900 in Austin or (800)531-5441, ext. 3-4900.

BULK RATE
U.S. POSTAGE PAID
AUSTIN, TX
PERMIT NO. 1411