Texas Conservative Coalition Research Institute

Testimony to the Senate Committee on Finance

December 3, 2019

Regarding the Committee's Charge: *Study the economic dynamics of the current business personal property tax. Consider the economic and fiscal effects of increased exemptions to the business personal property tax, versus its elimination. Following such study, make recommended changes to law.*

Background

While Texas is a low-tax state overall, its property taxes- which are imposed by local governments rather than by the state- are quite high relative to most of the country. Texas had the sixth-highest property tax burden in the nation in 2016, according to the Tax Foundation.[1] Other measurements place Texas behind only New Jersey, Illinois, and Vermont in terms of effective property tax rates.[2]

Over the years, Texas has made efforts to lower the property tax burden its residents face through such measures as a 10 percent cap on annual increases in the appraised value of homestead residences and, in the 86th Session, Senate Bill 2 and House Bill 3. SB 2 lowers the "rollback" rate for cities and counties and school districts to 3.5 percent and HB 3 will generally cap the annual growth in a school district's taxes at 2.5 percent starting in 2021.[3]

Part of the state's heavy property tax burden is reflected in its broad general rule that tangible personal property used for the production of income, such as a business's machinery, furniture, supplies, and inventory- is subject to local property taxes. This tax on tangible personal property tax used for the production of income is sometimes informally referred to as the "business personal property tax ("BPPT").

Overview of the BPPT

Generally, taxpayers must submit a rendition statement of all tangible personal property used for the production of income that they own, or manage and control as a fiduciary, as of January 1st of a given year.[4] The rendition statement is filed with the appraisal district office in the county in which the property is taxable.[5] Taxable property is then subject to local governments' standard property tax rates.

There are numerous exemptions to the BPPT; the table below lists some of the larger or better-known exemptions. The figure adjacent to each exemption is the "cost" of the exemption, i.e., the property tax revenue forgone by local governments state-wide as a result of the exemption.

Table 1:

Exemptions Applied to the Business Personal Property Tax (2019)

Exemption	Value of the Exemption in 2019
For income-producing personal property valued at under $500	$0.3 million
For farm products	$0.3 million
For offshore drilling equipment not in use	$0.5 million
For mineral interests worth less than $500	$1.1 million
For solar and wind energy devices	$1.1 million
For railroad rolling stock	$25.8 million
For motor vehicles leased for personal use	$36.3 million
For pollution control property	$141.8 million
For freeport property[6] and cotton stored in warehouses	$417.9 million
For tax increment financing	$254.4 million*
For projects under the Texas Economic Development Act (Chapter 313)	$584.9 million*

*Figure includes the total cost of tax exemptions for both real property and non-inventory tangible personal property.
Source: Comptroller, *Tax Exemptions & Tax Incidence,* November 2018.

As the table below illustrates, the BPPT generates significant revenue for local governments. In 2017, business tangible personal property constituted 10.6 percent of the statewide property tax base and the BPPT generated approximately $6.3 billion in revenue.

Table 2:

Revenue from the BPPT (2014-2017)

	2014	2015	2016	2017
School District Taxable Value of Property in the State	$2,022,608,993,697	$2,110,354,898,939	$2,212,416,373,472	$2,372,613,114,570
Estimated School District Taxable Value of BTPP*	$245,186,179,357	$256,792,798,262	$252,357,428,244	$251,702,775,926
Estimated Percentage of School District Taxable Value Consisting of BTPP**	12.12%	12.17%	11.41%	10.61%
Total Property Tax Levy in the State***	$49,106,716,988	$52,200,572,792	$56,078,877,952	$59,405,007,493
Estimated Property Tax Levy on BTPP****	$5,952,850,183	$6,351,884,778	$6,396,590,438	$6,302,083,217

Source: The underlying data is from the Comptroller, *Biennial Property Tax Report, 2016 and 2017* and *Biennial Property Tax Report, 2014 and 2015 (collectively, the "Comptroller's Biennial Tax Reports").*

"BTPP" in the above table refers to business tangible personal property.

**This estimate is derived by summing the school district taxable values for Commercial Personal, Industrial Personal, and Special Inventory (categories L1, L2, and S, respectively) in the Comptroller's Biennial Tax Reports.*

***This estimate is obtained by dividing School District Taxable Value of Property in the State by Estimated School District Taxable Value of BTPP.*

****This estimate is determined by adding together the property tax levies by school districts, cities, counties, and special districts, as they are set forth in the Comptroller's Biennial Tax Reports.*

*****This estimate is calculated by multiplying the Total Property Tax Levy in the State by the Estimated Percentage of School District Taxable Value Consisting of BTPP. This number is approximate; because property tax rates vary by local taxing unit, total revenue from BTPP is not necessarily the same as the number that is equal to the product of the Total Property Tax Levy in the state and the Estimated Percentage of School District Taxable Value Consisting of BTPP.*

Economic Dynamics of the Current BPPT

Several aspects of the BPPT make it poor tax policy. First, it violates the principle of "horizontal equity," the idea that similarly situated taxpayers should be treated equally. Under current Texas law, a business must pay property taxes on the tangible personal property it holds for the production of income (inventory, furniture, equipment, supplies, etc.). Intangible property, however, is generally exempt from the BPPT (although a few types of intangible property are taxable). A retailer, for example, potentially faces a significant burden under current law in that its inventory is subject to property tax. Similarly, a manufacturing business may face high taxes as a result of the machinery it uses in the manufacturing process. In contrast, service-oriented businesses, such as software companies and accounting and law firms, are far less likely to face significant property taxes on their property because the bulk of their assets are often intangible.

Second, the BPPT imposes compliance costs on businesses. In cases where taxation is appropriate policymakers should aim to minimize the transactional and compliance costs associated with the tax. However, property taxes are generally costly to administer and comply with when compared to other forms of taxation. Under the current BPPT system, a business must determine the value its tangible assets in preparing its rendition statement to the applicable appraisal district. Although a taxpayer may submit a good faith estimate of value, the taxpayer must be prepared to defend this estimate. Even a small business may have dozens of items for which a value must be reported, and determining what the value of an item can involve significant research by the taxpayer. Alternatively, a taxpayer may provide the historical cost of the item of property and the year in which it was purchased, but this requires a taxpayer either to keep records of his or her purchases for a long period of time, and in some cases to know what the previous owner of an item of property paid for it. A dispute between a taxpayer and the appraisal district over the value of the taxpayer's tangible personal property must be settled at an appraisal review board hearing or in court. Many taxpayers opt to retain professional assistance in calculating or contesting their BPPT liability, which of course imposes further costs on them.

The BPPT imposes compliance costs not just on taxpayers, but also on local governments. In 1995, the Texas Legislature passed House Bill 366 (74R), which, in conjunction with House Joint Resolution 31, established a $500 exemption for taxpayers subject to the BPPT.[7] HJR 31 provided in part that:

> The Legislature may exempt from ad valorem taxation tangible personal property that is held or used for the production of income and has a taxable value of less than the

minimum amount sufficient to recover the costs of the administration of the taxes on the property, as determined by or under the general law granting the exemption.

As the House Research Organization's analysis of HB 366 explained, some counties were incurring administrative costs with respect to properties with little value that were subject to the BPPT, to the point that the administrative costs exceeded the revenue raised by the tax.[8] It should be noted that the $500 exemption is not indexed to inflation, even though that would be appropriate given the rationale for its creation.

A third aspect of the BPPT which makes it poor policy is that it applies to businesses even when those businesses are operating at a loss. Businesses often incur losses in their first several years of existence. Startups, struggling businesses, and capital-intensive businesses are especially vulnerable to shouldering a tax burden which is entirely disconnected from their profitability or their ability to pay the tax. Ideally, startups should be directing their cash flow into expanding their workforces and developing their offered products and/or services, rather than dealing with an administratively burdensome tax. The burden of the BPPT on small and new businesses is exacerbated by the lack of a cap on the tax; in contrast, annual increases in the appraisals of residential real property, for example, are generally capped at 10 percent.

Fourth, the BPPT distorts economic behavior. While all taxes affect behavior to some extent, policymakers should aim to disrupt the interactions of businesses and consumers as little as possible so that a free market can function most efficiently. In the case of the BPPT, businesses have an incentive to minimize their capital investment and inventory holdings. For example, a business considering a purchase of expensive machinery to more efficiently produce goods may opt instead to use less efficient manual labor in light of the BPPT. In turn, this decision results in lower productivity, stunting economic growth. As the Tax Foundation has stated, "There is evidence that the elimination of [the BPPT] increases investment in capital. In Ohio, policymakers exempted manufacturing equipment from the state's [BPPT], resulting in greater capital investment and a shift from labor."[9] Similarly, a company may refrain from ordering additional inventory due to concern that its holdings will be subject to the BPPT.

Economic Effects of Increased Exemptions to the BPPT

Repealing the BPPT should be the goal of the Legislature, but if that cannot be accomplished, increasing exemptions to the BPPT would still provide substantial economic benefits to the state. While a BPPT is flawed by its nature, there are several aspects about Texas' version that make it particularly burdensome

First, as noted above, Texas has very high property tax rates relative to most of the country. Thus, all else being equal, an exemption from property tax in Texas is more valuable than in other states.

Second, Texas is the largest-producing state of both oil[10] and natural gas.[11] Given the size of its oil and gas industry, Texas is an especially poor place in which to impose a BPPT, which by its nature burdens capital-intensive industries in particular.

Third, according to the Tax Foundation, 43 states include tangible personal property in their tax base to at least some extent, but Texas is one of only eight states that fully taxes inventory (subject to exemptions such as the Freeport exemption).

Finally, and perhaps most importantly, Texas' base exemption of $500 is trivial. Assuming a combined local property tax rate of 2.5 percent, the current $500 exemption is worth a meager $12.50 each year. The inadequacy of Texas' base exemption is apparent when comparing it the corresponding figures for other states:

Table 3:

Exemptions from Business Personal Property Taxation by State

State	Base Exemption
Oregon	$17,000
Nebraska	$10,000
Montana	$100,000
Florida	$25,000
Washington	$15,000
Colorado	$7,700
Utah	$10,800
Idaho	$100,000
Indiana	$40,000 (per county)
Delaware	Full (no tax)
Hawaii	Full (no tax)
Illinois	Full (no tax)
Iowa	Full (no tax)
New York	Full (no tax)
Ohio	Full (no tax)
Pennsylvania	Full (no tax)
Minnesota	Full, except for certain centrally-assessed BTTP*
South Dakota	Full, except for certain centrally-assessed BTTP
New Jersey	Full, except for certain centrally-assessed BTTP
New Hampshire	Full, except for certain centrally-assessed BTTP
North Dakota	Full, except for certain centrally-assessed BTTP

Source: All data is from the Tax Foundation, "States Should Continue to Reform Taxes on Tangible Personal Property," (Aug. 2019), except for Indiana, which updated its statute in 2019.

*The five states with the exemption of "Full, except centrally-assessed BTTP" exempt most tangible personal property except for certain centrally-assessed industries, such as public utilities or oil and natural gas refineries.

Increasing exemptions to the BPPT (or eliminating it altogether) would likely provide a net benefit to the state. A corollary of the BPPT's distortion of economic behavior is that businesses have a strong incentive to operate in low-tax jurisdictions. Indeed, much of the "Texas Miracle" is credited to Texas government out-competing other states by welcoming migrating and new businesses through a combination of low taxes and light regulation.

Ohio is an instructive example; the state overhauled its tax system in 2005, which among other things eliminated its BPPT on new investment in manufacturing and phased out its BPPT on other business tangible personal property. For the next four years, Ohio won Site Selection Magazine's "Governor's Cup" award as the state with the most major business expansion projects.[12] This success has been lasting; Ohio has earned the second-highest ranking the last five years.[13]

Texas is perhaps an even better example of how economically powerful reducing BPPT can be- it is the winner of the Governor's Cup the last seven years.[14] Although Texas has a BPPT, unlike Ohio, the state grants generous BPPT exemptions to many companies relocating to, or starting in, Texas. For example, the Texas Economic Development Act (sometimes referred to as "Chapter 313") grants school districts the authority to enter into tax incentive agreements with businesses in exchange for promised economic development, such as capital investment and job creation. Under these tax incentive agreements, qualifying businesses are exempted from paying all or a portion of school district maintenance and operations ("M&O") taxes that would otherwise be due on commercial buildings and non-inventory business tangible personal property over a period of ten years.

While Chapter 313 is a complex program with advantages and disadvantages, the Comptroller reports that, through 2017, Chapter 313's tax incentives have resulted in businesses investing $120 billion in the state.[15] The rationale for Chapter 313's tax incentives also applies to increasing BPPT exemptions; businesses seeking expansion are likely to invest in jurisdictions with lower property tax burdens. Unfortunately, Chapter 313 is targeted exclusively at large investments by companies and does not offer property tax relief to most small businesses.

Fiscal Effects of Increased Exemptions or Elimination of the BPPT

Estimating the fiscal effect of increased exemptions to the BPPT is challenging. In the 84th Legislative Session, Senate Bill 763 would have exempted the first $50,000 of business tangible personal property from property taxes, a substantial increase to the current $500 exemption. Although the bill did not pass, its accompanying fiscal note projected that the increased exemption would reduce school district maintenance and operations property tax collections by $176 million in FY 2019 and city and county property tax collections by another $215 million. While city and county property tax revenue declines must be borne at the local level, the state's school finance formulas require the Legislature to make school districts whole from effects of increasing BPPT exemptions. Therefore, the biennial cost to the state was projected to be approximately $350 million.

More recently, SB 730 (85R) and SB 1006 (86R) would have increased the $500 exemption to $2,500. The former bill's fiscal note estimated that in 2020 (the first year in which the bill's full effects were felt), the state would have to make up $2.4 million of lost school district tax revenue and that cities and counties would sustain a total revenue loss of around $160,000 each. Senator Bettencourt's statement of intent, however, explained that:

> Since the cost of appraisal and collection of the business personal property tax [with respect to taxable values between $501 and $2,500] exceeds the tax revenue received, appraisal districts' and tax assessors' resources are ineffectively used to administer the business personal property tax….The current $500 exemption amount was established in 1995 and has never been adjusted. The purpose of the increased exemption amount is to eliminate the net tax revenue loss related to appraising and assessing the business with tangible personal property worth less than $2,500.

Based on data from the Comptroller discussed above, elimination of the BPPT would cost local governments approximately $6.3 billion. It is possible that some of this loss would be borne by the state as a result of the school funding formula. This estimate, however, is not "dynamic"; in other words, it does not account for the economic benefits that would result from elimination of the BPPT. For example, businesses would have more funds for capital investment and for paying higher salaries, which (all else being equal) would likely increase state sales tax revenue collections as well as other related taxes.

Recommended Changes to the Law

The BPPT is a flawed tax that penalizes certain types of businesses, such as capital-intensive businesses and retailers, is administratively burdensome, applies to businesses regardless of profitability, and erodes the state's competitive edge relative to other states. The Legislature should work toward the long-term goal of eliminating the tax in light of these inherent flaws.

The flaws of the BPPT bear a striking resemblance to those of the much-criticized franchise tax. One important difference between the two taxes is that the Legislature has acted to minimize the burden that the franchise tax places on small businesses in particular. Businesses with gross receipts below the "no tax threshold" of $1.18 million (for the 2019 tax year), which is indexed for inflation, are exempt from paying the tax. In addition, taxpayers with a calculated tax liability of less than $1,000 are excused from paying the tax. In 2017, of the 1.3 million businesses potentially subject to the franchise tax, only 121,000 actually owed tax due to these exemptions.[16]

In contrast, the base exemption for the BPPT is only $500 and therefore small businesses still feel the impact of the tax. If the Legislature is not able to repeal the BPPT, it should consider increasing the exemption substantially to $50,000 and indexing the increased exemption to inflation. Assuming an average combined local property tax rate of 2.5 percent, the $50,000 exemption would provide meaningful tax relief ($1,250) each year to small businesses.

Notably, because Article VIII, Section 1(g) of the constitution essentially requires that the property exempted from the BPPT be such that the cost of administering the tax on the exempted property would (but for the exemption) exceed the revenue raised by taxing it, a constitutional amendment (such as Senate Joint Resolution 36, 84R) would likely be necessary to increase the exemption to $50,000.

Finally, pursuing a similar approach to SB 730 and SB 1006 and raising the exemption to $2,500 would also have clear economic benefits. Both bills passed the Senate unanimously and this approach would represent a strong first step toward providing lasting and substantial relief from the BPPT.

ENDNOTES

[1] "Tax Foundation, *Facts and Figures* (2018), available at https://files.taxfoundation.org/20180411102900/Facts-Figures-2018-How-Does-Your-State-Compare.pdf (based on 2016 data).
[2] Attom Data Solutions, "U.S. Property Taxes Levied on Single Family Homes in 2017 Increased 6 Percent to More Than $293 Billion," (April 3, 2018), available at https://www.attomdata.com/news/market-trends/home-sales-prices/attom-2017-property-tax-data-analysis/
[3] Revenue from a given school district's maintenance and operation ("M&O") taxes could grow faster than 2.5 percent in some years if certain circumstances exist, e.g., in a year in which property formerly excluded from school district M&O property tax rolls pursuant to property tax incentives under Chapter 313 of the Tax Code first appears on property tax rolls at its fair value.
[4] Section 22.01(a), Tax Code.
[5] Section 22.23, Tax Code.
[6] The freeport exemption applies to goods, wares, ores and merchandise other than oil, gas and petroleum products and to aircraft or repair parts used by a certificated air carrier. The freeport goods qualify if they leave Texas within 175 days from the date they are brought into or acquired in the state. For more detail, see Comptroller, "The Freeport and Goods In Transit Exemptions" (undated), available at https://comptroller.texas.gov/economy/local/transit-exemptions/
[7] Codified as Section 11.145, Tax Code.
[8] House Research Organization, Bill Analysis of House Bill 366 (April 12, 1995), available at https://hro.house.texas.gov/pdf/ba74r/hb0366.pdf#navpanes=0
[9] Tax Foundation, "States Should Continue to Reform Taxes on Tangible Personal Property," (Aug. 2019), available at https://taxfoundation.org/tangible-personal-property-tax/#_ftnref28
[10] United States Energy Information Administration, "Oil: Crude and Petroleum Production Explained" (undated), available at https://www.eia.gov/energyexplained/oil-and-petroleum-products/where-our-oil-comes-from.php
[11] United States Energy Information Administration, "Frequently Asked Questions" (undated), available at https://www.eia.gov/tools/faqs/faq.php?id=46&t=8
[12] Site Selection Press Release, "Ohio Wins Site Selection Magazine's Governor's Cup Award for 2009" (March 3, 2010), available at https://siteselection.com/press/releases/100303.htm?_ga=2.227949405.1516866566.1575299989-913645058.1575299989
[13] Business Wire, "Ohio Leads Site Selection's Governor's Cup Rankings for Fifth Consecutive Year," (March 4, 2019), available at https://www.businesswire.com/news/home/20190304005646/en/Ohio-Leads-Site-Selection%E2%80%99s-Governor%E2%80%99s-Cup-Rankings
[14] Jonathan Tilove, "For 7th Straight Year, Texas Wins Governor's Cup for Economic Development," *Austin American-Statesman* (March 4, 2019), available at https://www.statesman.com/news/20190304/for-7th-straight-year-texas-wins-governors-cup-for-economic-development
[15] Comptroller, *Report of the Texas Economic Development Act, 2019.*
[16] Texas Taxpayers and Research Association, "Texas Franchise Tax" (July 2018), available at https://ttara.org/wp-content/uploads/2018/11/FranchiseTaxReport_Final.pdf