

Testimony on SB1221

April 9, 2009

Glenn Callison

Mr. Chairman, Vice Chairman, Senator Shapiro and distinguished members of the Senate Finance Committee – thank you for the opportunity to speak to you today. My name is Glenn Callison and I am the Public Affairs Chair for NAIOP North Texas, Commercial Real Estate Development Association, representing 270 member companies in Texas, and more than 18,000 members in North America. I also serve as Chairman and CEO of Munsch Hardt Kopf & Harr, a Texas law firm with offices in Dallas, Houston and Austin. We represent many clients who are developers, owners, landlords and tenants of commercial real properties.

I support the SB 1221 substitute because I, too, believe it will correct a basic inequity in the revised franchise tax. During the last legislative session, we were under the impression that the franchise tax would apply only to net commercial rental income rather than gross rents and expenses. However, when the law was amended to apply to gross income and expenses in the closing days of the last session, we scrambled to effectively communicate our message regarding the fundamental unfairness of including commercial pass-through payments. As we stated then, such pass through payments (that are typically deductible under federal income tax) should not be taxable under a gross tax regime because they provide no income to the landlord. We are here today to reaffirm that position. In response to Senator Seliger's concerns, pass-through payments are not expenses and "costs of business" for the landlord, but rather are the expenses of the tenant that are simply collected by the landlord and passed through to taxing authorities, utilities and vendors.

The substitute language for SB 1221 has the same effect as drafted in the original bill. The revisions proposed are meant to tighten the bill language and focus on the most traditional forms of pass-through payments – taxes, insurance, utilities and maintenance expenses. This was an attempt to avoid any unintended payments from being classified as pass-through payments. For example, in the original bill we listed “management expenses and similar amounts generally expended for commercial real property” as possible pass-through payments. We recognized that language as overly broad in scope and we removed it to be more concise. We firmly believe this will reflect positively in the revised fiscal note for the substitute bill.

While addressing the revised franchise tax, there is one myth I would like to dispel. It has been suggested that the landlord’s franchise tax liability was offset by the property tax relief that was enacted in 2006. Unfortunately, my clients did not see this reduction for two reasons. First, many commercial landlords saw their property tax liability stay the same or increase in 2007 because appraisals went up. Clearly, this was prior to the current economic downturn. However, even in a down economy, commercial landlords will not benefit from property tax reductions because their leases are typically structured in a way that requires them to pass 100% of the property tax savings through to the tenants. Thus, it is inaccurate to say that a reduction in property taxes helped to offset the higher franchise tax liability.

In a recent survey done by The Real Estate Council of Dallas and the North Texas NAIOP, 97% of landlords surveyed affirmed that commercial pass-through payments should be excluded from their gross income. Those surveyed were landlords of property classes - retail, office, industrial and mixed-use. A majority said they saw no reduction in their property taxes in 2007 or 2008. A large number of those surveyed are commercial landlords of multi-tenant properties that are collecting these pass through payments. These

taxpayers range from large institutional owners of millions of rentable square feet of office and industrial space to mom and pop investors of neighborhood retail strip centers.

As a result, you can see the significant impact that the franchise tax has had on a broad cross section of our industry, and consequently, on our Texas economy. Whether we disagree philosophically on whether the franchise tax should remain is not why we are here today. That is an argument for another time. All we ask at this time is that we are treated fairly under the current franchise tax regime by excluding commercial pass-through payments from the landlord's gross income. I encourage you to support the substitute language for SB 1221.

Thank you for your time.

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Macey Davis

Thank you, Chairman Ogden, Vice Chairman Hinojosa, Senator Shapiro and distinguished members of the Senate Finance Committee. I appreciate the opportunity to speak to you today. My name is Macey Davis and I'm the Chair of the Real Estate Councils of Texas, a statewide coalition representing the commercial real estate industry of Austin, Dallas, Ft. Worth, Houston and San Antonio.

According to the Texas A&M Real Estate Center, the commercial real estate industry is the third most important industry in the Texas economy. In a recent study done by TXP, Inc., regarding the impact of our industry in 2007, we generated more than \$270.6 billion in total economic activity, employed more than 1.75 million people for a total labor income of \$76.8 billion and generated \$3.8 billion in state tax revenue.

The franchise tax has had an enormous impact on our industry. Today, I am here to express my strong support for the committee substitute of Senate Bill 1221 to exclude from a commercial landlord's gross income certain pass-through payments that are currently subject to the franchise tax.

A typical multi-tenant commercial lease is set up in a way that allows the tenant to pay his base rent plus additional amounts for his pro-rata share of taxes, insurance, utilities and common area maintenance. These additional amounts are commonly referred to as pass-through payments. The reason for this reference is because these payments literally flow from the tenant through

the landlord to a third party demanding payment. These third parties can include the appropriate taxing authority, the insurance company and the property maintenance company.

The landlord does not rely on these funds for profit, business or personal use. He is merely acting as a middle man by collecting these funds and passing them through to the appropriate entity.

These pass-through payments are not income to the landlord. Unfortunately, they are being treated as income under the new franchise tax regime and are being taxed as such. This approach is patently unfair and the result of this inequity is either a tax on a tax or double taxation of funds that are revenue to someone else, not the landlord.

As you can see, we are not here today to argue against paying our share of the franchise tax. We are here to talk about whether the tax is fair as it applies to commercial leases. A landlord of commercial real property should not be taxed on phantom income, and pass-through payments are just that: phantom income. We hope you will support the committee substitute of SB 1221 and eliminate this inequity under the current franchise tax by excluding pass-through payments from the commercial landlord's gross income.

Thank you for your consideration. I look forward to any questions.