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S&P Bulletin: Proposed Sales Tax Changes In Texas Would Transform Revenue Distribution

FARMERS BRANCH (S&P Global Ratings) Feb. 13, 2020– A proposed change to sales tax collections in Texas would likely lead to a modest increases in revenues for most cities. In limited cases where an entity issued debt secured by sales tax and has a concentration of online market places, warehouses, and distribution facilities, we would anticipate a degree of sales tax volatility which could weaken credit quality.

On Jan. 3, the Texas comptroller proposed changes to the tax code including a change to destination-based sales tax allocations for qualifying internet sales, eliminating origin-based distribution. Currently in Texas, sales taxes on internet purchases are allocated to the city where the online order is received. This favors municipalities with major online market places, warehouses, and distribution facilities that fulfill internet orders. With the proposed change, sales taxes would be credited to the purchase's destination. S&P Global Ratings believes that given this broader geographic reach, a majority of Texas municipalities would benefit from the proposed change.

However, given the shift considered under the proposal, there could be a more significant impact to credit quality for issuers who stand to lose a reliable revenue source. The proposed rule change includes a grandfathering provision that would extend certain economic development agreements until Dec. 31, 2022, allowing affected entities some time to explore alternative forms of revenue and cost saving initiatives. However, any long-term bonds secured by sales taxes could see some impairment after that date.

A number of Texas cities entered into economic development agreements with the understanding that sales taxes derived from online purchases would be sourced from their respective city and assist in managing the total property tax rate. Several cities have publicly indicated the change in the distribution of sales tax collection would result in structural budget gaps due to the lost revenue. We understand, through discussions with city representatives, that sales tax collections derived from business-to-business (B2B) sales could also be negatively affected due to the proposed redefinition of "internet order." Essentially the proposed language defines internet orders as purchases by any method related to the internet regardless of the type of electronic device. As a large number of companies execute commercial transactions via the internet, Texas cities with a large commercial presence could see a loss in annual sales tax revenue derived from B2B sales.

While measuring the effect at this point is difficult given online transactions are not generally disaggregated from total sales tax collection with the continued shift of consumer spending towards e-commerce, we anticipate most Texas cities are likely to experience modest increases in sales tax collections. As noted by the U.S. Commerce Department e-commerce reports, U.S. e-commerce sales as a percentage of total retail sales increased to 11.2% in the third quarter of 2019 from 3.4% in 2009, representing a growing share of the retail market that Texas cities can capitalize on.

The state comptroller is also enacting provisions under precedent set by the United States Supreme Court in South Dakota v. Wayfair (2018) and recent Wayfair-related legislation passed during the

2019 Texas legislative session which overruled a longstanding physical-presence statute, allowing states to require remote sellers to collect and remit sales tax. The proposed rule changes is intended to provide guidance to Texas local governments' and to clarify sourcing from online sales tax collections. Regardless of the outcome of the proposed change, our analysis will continue to focus on entities' ability to maintain structural balance while mitigating the impact of lost revenue- sales tax or otherwise. We will continue to monitor the proposed change and its potential effect on Texas local governments' credit quality.

This report does not constitute a rating action.