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GEORGIA'S CORPORATE INCOME AND NET WORTH TAXES

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Executive Summary

This report discusses issues regarding the two major business taxes in Georgia: The corporate income tax and the net worth tax. The corporate is based on a company's profit while the net worth tax is based on the value of a company's total assets.

There are several arguments made by citizens for taxing businesses. However, most of these reasons ignore that businesses, including corporations, are pass-through entities. A tax on a corporation is borne by its shareholders, employees, and customers. Thus, corporate income taxation has economic effects beyond the corporation itself. The most economically persuasive rationale for the taxation of business is to compensate the state for services rendered by the state.

Currently, the Georgia corporate income tax is the third largest contributor to state revenues behind the personal income tax and the state sales tax. While important in terms of revenue, the tax is an unstable revenue source for two reasons. First, the tax base (profits) fluctuates widely over the business cycle. Second, the tax base is "leaky" in the sense that the tax is becoming a smaller portion of the state's tax revenues.

This loss of revenue is likely due to a combination of factors such as: the increased use of tax credits; the use of sophisticated tax planning; the use of different organizational forms to avoid the corporate income tax; and changes in the apportionment formula. These factors are likely to have had a significant effect on the diminished ability of the tax to generate revenue.

The net worth tax, while never a large contributor to the state's tax receipts, has become even less important over time.

There are five potential major changes to the Georgia corporate income tax that might be considered by the state. The first is the need to reexamine nexus requirements. Nexus is the legal and constitutional right of the state to tax the economic activity of a potential taxpayer. Policy makers may need to address issues of whether expansion or reduction of Georgia's nexus requirements is

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desirable in light of technological changes that make the location of production or sales more difficult to determine.

Second, the issue of the apportionment formula might be revisited. Georgia adopted a double weighted apportionment formula in the mid 1990s and there has been discussion to change the apportionment formula to a single factor approach based on sales. Evidence shows that there will be winners and losers from a change to a single factor apportionment formula, but any benefits are likely to be found only in the long-term.

Third, Georgia permits firms to use "separate accounting." With separate accounting, each firm in a group of related companies may account for their tax liability separately rather than in a combined tax return. Separate accounting has problems. It allows corporations to employ sophisticated tax strategies to shift income overseas or to other states. The use of separate accounting will only increase without changes to how corporations report their company-wide income. However, it should be noted that states might compete on how they allow firms to report, just as they do with other parts of the tax code, so as to attract business to the state.

Fourth, an alternative minimum tax (AMT) could be employed to reduce the "deterioration" of corporate revenues to the state. The AMT does not really solve any problems, but it may prolong the time before they have to be dealt with properly.

Finally, the state might consider replacing business taxes with an activity tax such as the value-added tax (VAT). The VAT is a tax on the value added at each stage of production. It is used in two states in the U.S., but is more common internationally. The imposition of a VAT in Georgia needs a careful consideration. If a full reform of Georgia's tax system is undertaken, an examination of the VAT is warranted as the VAT has a number of benefits. However, it does come with some increased administrative costs. Alternatively, if there is no major reform of the overall Georgia tax system, the VAT may be employed as a complementary tax rather than a replacement tax. This may be useful to offset the erosion we observe in the corporate income tax.

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Introduction

This report discusses issues associated with the two major taxes used by the State of Georgia to tax corporations: The *net worth tax* and the *corporate income tax*.¹ The net worth tax is a tax based on the value of the company's total assets. In contrast, the corporate income tax is based on the company's profit in a given year.

In general, the two taxes have declined in relative importance over time. Table 1 shows the relative size of the corporate income tax and the net worth taxes on Georgia companies for three time periods, 1990, 2000 and 2001. We look at these three periods to make a number of points.

Panel A shows the results from fiscal year 2001. In 2001, the corporate income tax was approximately 97 percent of the total business taxes. The net worth tax brought in the remainder. In addition, the corporate income tax represented less than 5 percent of total tax collections. Since 2001 was a year experiencing the beginning of a recession, the results need to be put into context. This can be done by examining Panels B (fiscal year 2000) and C (fiscal year 1990).

Over the decade 1990-2000, the percentage of taxes coming from corporations fell from 6.98 percent to 5.12 percent. Corporate income taxes were a less reliable source of income in 2000 than in 1990, even accounting for a positive real annual growth rate of almost 4 percent in corporate tax revenues over the decade. In addition, Panels B and C show that the Net Worth Tax collections as a percentage of total taxes has remained relatively stable at approximately 0.26-0.27 percent. It is interesting to note that the absolute value of net worth tax collections increased over the period 1990-2000. However, there is only about a \$2 million difference between 1990 and 2001. Thus, the 2001 recession seems to have greatly affected net worth tax receipts.

¹ In addition to these taxes Georgia also taxes financial institutions and insurance companies. Banks are subject to the financial institution occupation tax. However, as the tax is creditable against a bank's income tax, a separate discussion is not warranted. A second tax on companies doing business in the corporate form is the insurance premium tax. Because this premium tax is different than the general corporate tax it is discussed more fully in a separate report, see Martin F. Grace, *Insurance Taxation in Georgia: Analysis and Options*, [Fiscal Research Program Report No. 17](#), (1998).

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TABLE 1
PANEL A. RELATIVE SIZE OF BUSINESS TAXES, FY 2001

	FY 2001	Percent of Business Taxes	Percent of Total Taxes
Company Tax			
Net Income	\$690,327,713	97.13%	4.95%
Net Worth	\$20,371,628	2.87%	0.15%
Total Business Taxes	\$710,699,341	100.00%	5.10%
Total Taxes Collected	\$13,934,125,749	---	---

SOURCE: Georgia DOR, Statistical Report (2001).

PANEL B. RELATIVE SIZE OF BUSINESS TAXES, FY 2000

	FY 2000	Percent of Business Taxes	Percent of Total Taxes
Company Tax			
Net Income	\$667,320,938	95.24%	5.12%
Net Worth	\$33,317,137	4.76%	0.26%
Total Business Taxes	\$700,638,075	100.00%	5.37%
Total Taxes Collected	\$13,041,654,965	---	---

SOURCE: Georgia DOR, Statistical Report (2000).

PANEL C. RELATIVE SIZE OF BUSINESS TAXES, FY 1990

	FY 1990	Percent of Business Taxes	Percent of Total Taxes
Company Tax			
Net Income	\$475,033,160	96.28%	6.98%
Net Worth	\$18,338,297	3.72%	0.27%
Total Business Taxes	\$493,371,457	100.00%	7.25%
Total Taxes Collected	\$6,802,401,679	---	---

SOURCE: Georgia DOR, Statistical Report (1990).

Similarly, the 2001 recession affected receipts of the corporate income tax. The percentage of corporate income taxes to total taxes collected fell to 4.95 percent from fiscal year 2000's result of 5.12 percent. As economic activity decreases, corporate profits decrease, and the result is lower corporate income tax collections. Finally, total company taxes (corporate income and net worth) as a percentage of total tax collections were lower in fiscal year 2001 (5.1 percent) compared to fiscal year 2000 (5.3 percent). This difference is relatively small, but if compared to fiscal year

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1990 (Panel C), we see that the percentage of total taxes collected from corporations decreased from 7.25 percent.

As we will discuss further, this reduced importance is a pattern seen at the Federal level and across the states. However, one should note this is a static picture, and as we will show below, the amount of business taxes collected fluctuates relatively widely on a year-to-year basis. Thus, given the amount of tax collected and its potential variability, it is necessary to understand the issues involved in the taxation of business in Georgia.

Georgia is not alone in examining state corporate tax policy. During the last ten years many states altered important parts of their corporate income tax codes to accomplish policy goals. Most of the reforms changed the rate structure, changed the apportionment formula, or added business credits. While Georgia has not altered its tax rate or tax base, it has altered the apportionment formula and it has enacted significant economic development credits. We will discuss these reforms in light of the experience in Georgia.

This report is organized as follows. First is a presentation of the rationales for the taxation of business. Second, we present a description of the tax in Georgia as it is currently constructed in conjunction with a description of some recent trends. Third, we present some options for the possible modification of the corporate tax in Georgia. The last section contains a summary of the report.

Rationale for Taxing Business

Before discussing the company tax situation in Georgia it is also important to understand the general rationales behind the taxation of business. Oakland lists three primary reasons why individuals believe taxing business is a good idea.² First business taxation masks the cost of government. Citizens and political leaders often see this as an advantage. Voters may believe that taxing business is a good idea as it is perceived to reduce the voters' tax liability by shifting it to businesses. Public policy should discourage masking the costs of government. As Oakland states, "decisions on public finances are best made under circumstances in which the costs and benefits of public programs are as explicit as possible."³

A second reason for taxing business is based on the notion of ability to pay. It is commonly believed that corporations are the proper subject of taxation because of their size and control of resources. Thus, corporations appear to have a superior ability to bear the burden of taxation. This argument is commonly employed to make the tax system appear more equitable, i.e. those with greater ability to pay should pay higher amounts of their income.

However, a progressive tax structure that may make sense on equity grounds for individuals does not make sense for corporations. The reason for this difference is that businesses are not the ultimate taxpayers. Corporations are merely a set of contractual relations between capital owners, other resource owners, and the customers of the corporation. Taxes placed on businesses eventually flow through to individual stockholders, employees, suppliers, or customers.

For example, a tax on a corporation providing a public service such as electricity, which can be a large and profitable enterprise, will be passed on to stockholders if net profits fall, to employees if wages fall, or to consumers if prices rise. One cannot guarantee that all shareowners are wealthy individuals as many lower- or middle-income individuals may have invested in the corporation for

²This section is based upon William Oakland, "Business Taxation in Louisiana: An Appraisal", in Louisiana's Fiscal Alternatives ed. by J. A. Richardson (LSU Press: Baton Rouge) 1988: 159-187.

³*ibid*, p.165.

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retirement purposes. In addition, if we believe that the shareholder is the predominant payer of corporate income taxes, then as the percentage of individuals owning stock for investment and retirement purposes increases, the number and breadth of individuals paying the taxes also increases.

Employees can also be displaced or have wages lowered as a result of higher business taxes. Thus, employees can bear some of the burden of the tax. Customers may pay higher prices as the result of the tax. Lower-income customers, for example, pay a larger percentage of their income on necessities such as electricity. To the extent that a higher profit tax results in higher prices, the higher profits tax on a large profitable company, which appears to be progressive, is actually a regressive tax because of the relatively larger percentage of income that goes to paying the electric bill by the relatively poorer consumer.⁴

A third reason for taxing business concerns the attempt by states to export the tax liability to taxpayers outside the state. Many firms sell products in a number of states. If a tax causes firms to raise prices, non-residents can end up bearing a portion of the state's tax liability. Similarly, by taxing large publicly held corporations, with customers and owners spread throughout the nation, the state can export the tax. To the extent the tax is borne by capital owners or customers, it is then paid by many outside the state. This can be a popular justification for taxing business as state residents can enjoy a higher level of public expenditure supported by out-of-state residents.

There are problems with this rationale that affect the industrial base of the state. Suppose, for example, we have two states, one with a tax on business and one without. Suppose the company in the state with the tax on business tries to sell to customers in the state that does not tax business. Suppose further that this company tries to "export" the tax and pass along the tax in terms of higher prices. The firm will only be able to pass along the tax if, and only if, it has market power. As long as the other state's markets are competitive, the firm will not be able to pass along the

⁴A regressive tax is one that makes up a larger share of income for low-income households than for higher-income households. Thus, as income decreases a larger portion of one's income goes to paying the tax.

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tax as customers will choose the lower priced goods. Thus, in an attempt to raise prices and pass along the tax, the firm could lose market share to the firm's competitors in other states that are not subject to the tax. Attempting to export taxes through the business tax can make a state's own industries less competitive *vis a vis* other states. Further, if the company cannot pass along the tax to out-of-state consumers, it must pass it along to capital owners, employees, or consumers in its home state. This can reduce the profitability of the state's industry, reduce the state's employment opportunities, or potentially, increase the prices paid by its consumers.

In addition to the potential rationales for business taxation Oakland proposes, there are two others of note. The first is based upon the notion that individuals might otherwise escape taxation of corporate income if it was not collected at the corporate level. This argument confuses tax withholding or reporting with tax collection. While economists believe that corporations are pass-through entities, they can still withhold or report taxable income on behalf of the shareholder. Essentially this is what is done with the personal income tax. The employer corporation does not pay the employee's income taxes, but withholds taxes the employee is obligated to pay and reports taxable income to the government on behalf of its employees.

Second, the most economically persuasive rationale for the taxation of business is to compensate the state for services rendered by the state. This rationale is based on the premise that government often provides services to firms and that it is appropriate for the user of these services to pay for them. This argument has an appeal on the basis of both equity and efficiency. Those that benefit from the corporation's use of state resources should compensate the state for these services. Capital owners benefit from the state provision of services, as do employees and customers. Prices paid by customers will thus reflect the true costs of providing state services.

The motive for this type of business taxation is known as the *benefit principle*. The implementation of the benefit principle is difficult. Benefits received by the corporation from the provision of state services and goods are difficult to measure. More dramatically, it is difficult to even determine the appropriate services

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for which to charge businesses. For example, businesses benefit from a better-educated workforce that is more productive. It is tempting to tax business for educational services provided to them in the form of higher educated workers. However, a higher educated worker will likely receive higher wages as a result of his or her higher education. To tax businesses for educational services will, in effect, double charge business for education. Thus, it is important to charge business for those goods and services provided directly to it rather than for services rendered to employees or other inputs it uses in production of goods and services.

From the discussion above it is important to understand that corporations are not the ultimate taxpayers, rather the shareholders, employers and consumers are the true taxpayers. This is an important concern and should be kept in mind for the remainder of the report.

General Corporation Taxes

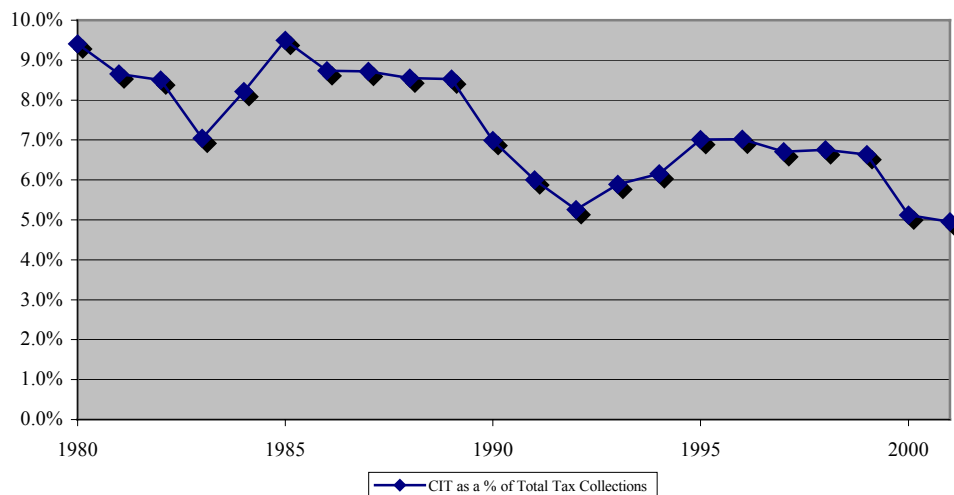
A. Corporate Income Taxation

1. History and Recent Trends

The corporation income tax was first introduced in Georgia in 1929. The tax rate has always been a flat proportional rate, fluctuating over time between 4 percent and 7.5 percent. The present rate of 6 percent has been in place since 1969. The corporation franchise tax, levied on net worth, is administered in conjunction with the corporation income tax. This is a relatively minor tax in terms of revenue production, and it will be discussed separately in Section B.

Decreasing importance: The corporate income tax is the third largest revenue producer for the state after the personal income and sales taxes and is closely followed by the motor fuel tax. However, its relative importance for state tax revenues has changed in the recent past. In 1980 the corporate income tax represented approximately 9.5 percent of state tax collections. In 1990 the corporation income tax was approximately 7 percent of state total taxes, and by 2001 it represented only 4.95 percent (Figure 1).

FIGURE 1. CORPORATE INCOME TAX (CIT) AS A PERCENT OF TOTAL TAXES COLLECTIONS, 1980-2001

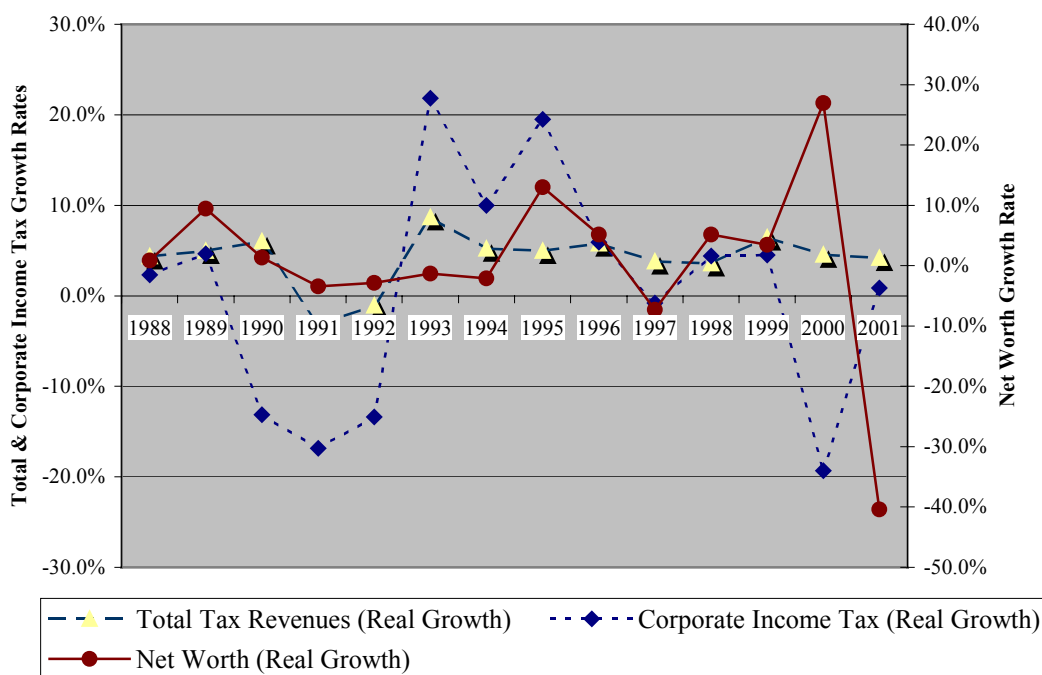


Source: Calculations made from Department of Revenue Statistical Reports and CPI data from the Bureau of Labor Statistics.

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Volatility of revenues: The most important reason for this lackluster performance is that the corporation tax is very sensitive to fluctuations in the economic business cycle; much more so than is the case for the individual income tax, the sales tax or the property tax. Figure 2 shows the real (i.e. inflation adjusted) growth rate of total corporate taxes, corporate income taxes, and the net worth tax over time. We see that real corporate income tax growth rates are volatile compared to the total tax collections growth rate. Further, the growth rate of the corporate taxes (both corporate income and net worth) are cyclical, corresponding to changes in the business cycle.

FIGURE 2. REAL GROWTH RATES FOR TOTAL TAXES REVENUES, CORPORATE INCOME TAX REVENUES, & NET WORTH TAX REVENUES, FOR GEORGIA, 1987-2001



Source: Calculations made from Department of Revenue Statistical Reports and CPI data from the Bureau of Labor Statistics.

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The growth rate in corporation tax revenues after adjusting for inflation is below 5 percent in the late 1980s. This growth rate turned sharply negative over the last three years. The more volatile nature of corporate income taxes *vis-a-vis* other revenues is also illustrated in Figure 2 where the rate of growth of corporate income taxes is compared to the growth of Georgia's total tax revenues and the Net Worth tax.

Behavior similar to that of other states: Georgia's corporate income tax revenues have not behaved markedly different from the typical corporation income tax in those states with income taxes. Corporate income taxes as percentage of total taxes almost perfectly shadow the experience of other states. Most states are also experiencing a general downturn in the importance of the corporate income tax relative to total tax revenues, a point that will be discussed further below. In addition, Table 2 shows that in 2000, Georgia was below the national average in the percentage of corporate income taxes as a share of total tax revenues. In the Southeastern U.S. it is among the highest. All southeastern states except North Carolina and Tennessee depend upon the corporate income tax to a lesser extent than Georgia.

TABLE 2. PERCENTAGE OF TAX REVENUES FROM THE CORPORATE INCOME TAX, SOUTHEASTERN U.S., 2000

	Percent Tax Revenues From CIT	Rank
Louisiana	3.40	1
South Carolina	3.60	2
Alabama	3.80	3
Kentucky	4.00	4
Virginia	4.50	5
Florida	4.80	6
Mississippi	4.80	7
Arkansas	4.90	8
Georgia	5.30	9
North Carolina	6.50	10
Tennessee	7.90	11
United States	6.00	

SOURCE: Bureau of the Census, State and Local Government Finances, <http://www.census.gov/govs/www/estimate.html>.

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2. *General Overview of the Corporate Income and Net Worth Taxes*

All domestic (Georgia) corporations, unless specifically exempt, are subject to the corporate income and net worth taxes.⁵ Further, foreign (non-Georgia) corporations owning property or “doing business” in Georgia are subject to these taxes. Companies that are taxable are establishments with business nexus in the state of Georgia.⁶ The interpretation of “doing business” in Georgia includes all activities for financial profit or gain.⁷ However, isolated transactions or the simple solicitation of sales do not come under the scope of the tax.⁸ The annual corporate franchise tax on net worth is imposed on both domestic and foreign companies. The State Revenue Commissioner issues the rules and regulations necessary for the administration and enforcement of these two taxes.

Domestic and foreign financial depository institutions (banks, savings and loans associations, and credit unions) have been subject to the corporation income tax and the franchise net worth tax since 1983. In addition, depository financial institutions pay two additional taxes: the “Local Business License Tax” which cities and counties may levy within their respective jurisdictions, and the “State Occupation Tax.”⁹ These two license taxes are levied at a rate of 0.25 percent each on gross receipts. The payments for these two taxes are creditable dollar-for-dollar against the financial institution's corporate income tax liability. This is discussed further below.

Insurance companies are exempt from the corporate income tax but they pay a state premium tax on gross premiums, with the rate ranging from 0.5 percent for companies investing in Georgia assets to 2.25 percent for companies with little or no investment in Georgia. There is also a local tax on insurance premiums collected by

⁵The major exceptions are for not-for profit corporations, insurance companies paying a premium tax, and mutual savings banks. OCGA § 48-7-25.

⁶OCGA § 48-7-20. Nexus, discussed further below is that minimal connection between a business and a state that will allow the state to legally tax a business.

⁷OCGA § 48-731(a).

⁸Public Law 86-272 (1959) codified at 15 USC §§ 381-385. Public Law 86-272 prohibits state taxation of net income from interstate commerce when the only within state activity is solicitation for sales of tangible personal property for which orders are subject to acceptance outside the state and are filled for shipment outside of the state. This prohibits the taxation of income from the mere solicitation of sales in Georgia by companies outside the state.

⁹OCGA § 48-6-93.

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the state and remitted to counties and municipalities based upon their relative populations. Insurance companies also pay the franchise tax on net worth.¹⁰

3. *Computation of the Corporate Income Tax*

Introduction: The computation of Georgia's corporate income tax starts with federal taxable income as the tax base.¹¹ This calculation of Georgia's corporation tax is described in Table 3. Corporations follow federal rules for accounting methods and periods. Other aspects of the tax conform basically to the federal corporate income tax, including such items as inventories, bad debts, and charitable contributions. Federal tax rules are also followed for depreciation of property placed in service in or after 1987. The federal Accelerated Cost Recovery System (ACRS) that became effective in 1981 was not adopted in Georgia so some adjustments to the Georgia definition of net income are necessary.¹² The net operating loss is computed under federal rules. However, only the amount of losses attributable to business in Georgia is allowed. Further, losses incurred when the corporation was not subject to taxation in Georgia are not allowed.¹³

Corporate Income Tax Base and Rate: The corporate income tax rate is a flat 6 percent and it is imposed on the Georgia taxable net income. To arrive at Georgia taxable net income (see Table 3), federal taxable income is adjusted by adding certain income exempt at the federal level and by eliminating deductions disallowed by Georgia and by subtracting interest on the holdings of financial obligations of the

¹⁰OCGA § 33-8-4. For a discussion of insurance taxation in Georgia, see Grace (1998) supra note 1.

¹¹OCGA § 48-7-27.

¹²OCGA § 48-7-27(c).

¹³OCGA § 48-7-27b(4). The net operating loss (NOL) works in the following manner. If a taxpayer experiences a NOL in a given year, the federal laws allow the company to amend its previous two years of tax returns to offset taxable income in the previous two years. If, in addition, the taxpayers still has additional losses that were not able to be applied to the two previous years of net income, it is possible to include the NOL against future income for up to 20 years. The important modification for the purposes of Georgia law is that if the taxpayer was not doing business in Georgia during the previous two years, the taxpayer would not be able to deduct the NOL from Georgia taxable income. The use of the NOL is permissible to the extent that the taxpayer corporation had experienced positive net income in Georgia in the past two years. This makes sense because if the company was not subject to taxation in Georgia, it should not be able to take a deduction against Georgia income.

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TABLE 3. CALCULATION OF GEORGIA TAX LIABILITY

Step 1 Calculation of Net Business Income	
<i>Start with Federal Taxable Income</i>	
Add:	Additions to Federal Taxable Income Non-Georgia State and Local Bond Interest Non-Georgia State and Local Income Taxes Expenses Attributed to Exempt Income New Operating Losses from Federal Return Other
Subtract:	Subtractions from Federal Taxable Income Interest on U.S. Obligations Other
<i>Equals Net Business Income (NBI)</i>	
Step 2 Calculation of NBI Apportioned to Georgia	
<i>Start with NBI</i>	
Subtract:	Income Allocated Everywhere
<i>Equals Business Income Subject to Apportionment (BISA)</i>	
Step 3 Calculation of Net business Income Apportioned to Georgia	
<i>Start with BISA</i>	
Business Income Subject to Apportionment * Double Weighted 3-Factor (.25*% Employment in GA + .5*%Sales in GA +.25*% Property in GA)	
<i>Equals Net Business Income Apportioned to Georgia (NBIAG)</i>	
Step 4 Calculation of Georgia Taxable Income	
<i>Start with NBIAG</i>	
Add:	Net Income Allocated to Georgia
Subtract:	Net Operating Losses Allocated to Georgia
<i>Equals Georgia Taxable Income</i>	
Step 5 Calculation of Georgia Tax Liability	
<i>Start with Georgia Taxable Income</i>	
Georgia Taxable Income*Tax Rate (6.0%)	
Subtract:	Credits
<i>Equals Georgia Corporate Income Tax Liability</i>	

U.S. This net business income is then either allocated to Georgia or apportioned to Georgia according to a measure of business done in Georgia.¹⁴

Apportionment and Allocation: An important distinction to make is the difference between allocable and apportionable income. Allocable income is that

¹⁴See OCGA § 48-7-31(c). Georgia allocates non-business income to Georgia for (1) interest on investments if the securities are located in Georgia; (2) for property held for investment purposes located in Georgia, and (3) for gains from the sale of tangible property that is not part of the business of the company if located in Georgia.

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income such as rents, royalties, capital gains from the sale of property or other so-called non-business income. In contrast, apportionable income is that income that arises out of the operation of the business and is apportioned to Georgia based on the amount of business done in Georgia relative to the rest of the country.¹⁵ Essentially apportionable income can be thought of as income from the sale of goods and services produced by the firm while allocated income is earned in a passive way. Once the income is allocated and the apportionable income is apportioned to Georgia (step 3 in Table 3), we have Net Income Allocated to Georgia. This becomes the tax base for the state income tax.

At least twelve states do not distinguish between allocable and apportionable income. These are known as “full apportionment states.” Many other states, including Georgia, distinguish between allocable and apportionable income.¹⁶ Most often what is apportionable and what is allocable depends on whether the income is defined as business or non-business income, respectively. Business income is generally defined as that earned during the regular course of business.¹⁷ The presumption for the distinction lies in the fact that some incomes are not earned by the application of factors of production but simply by the corporate entity itself and these should be situated, or located for tax purposes, where the corporation is domiciled. For example, dividend income from the ownership of stock of other companies is considered to be earned by the corporation in a way that is different from the income derived from production and sale of goods and services. Many of the distinctions made for such items as royalties and technical service fees as passive income have little economic justification, as income is fungible no matter the source.

As in other areas of state corporate taxation, the potential for double taxation of certain types of income increases because the same income may be considered apportionable in one state and allocable in another. This can be seen by an example.

¹⁵ The apportionment methodology is discussed more fully below.

¹⁶ OCGA § 48-7-31.

¹⁷ A number of states (not including Georgia) have passed a model or uniform tax law to rectify some problems with multiple taxing jurisdictions. This law, known as UDITPA (Uniform Distribution of Income for Tax Purposes Act), allocates only non-business income which is defined as originating in assets not in use for daily business activities. Thus signatory states do not double tax non-business income.

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Suppose a multistate taxpayer has \$100 in non-business income. One state where the firm operates uses an apportionment rule that states that all income (both business and non-business) be apportioned on the basis of the percentage of the company's sales within the state. Let us suppose that this apportionment in fact apportions 20 percent of the firm's non-business income to the state. Further, another state where the company has its headquarters and all of its intangible property requires that all non-business income located in that state is allocated to that state. In this example, the non-business income tax base is subject to double taxation: once in the state that requires allocation of the income (20 percent) and once in the state that requires apportionment of the income (100 percent).

The clear incentive for "headquarter" states is to classify income as allocable because 100 percent of it is taxed in the state. The disadvantage is that a very aggressive position on allocable income may cause some corporations to choose a different state for domicile. States with relatively few important company headquarters may be able to increase tax collections with the "full apportionment" approach in the sense that they will be able to be more aggressive in classifying income as allocatable income.

In Georgia, several income items are specifically allocated to the state and are not apportionable. Net investment income from intangible property (bonds held for investment and other income from intangible assets as well as rentals from realty held for investment) is allocated to the state of Georgia if the corporation's situs is in the Georgia.¹⁸ Net investment income from tangible property located in the state is also allocated to Georgia.¹⁹

Income (otherwise not specifically allocated) from manufacturing, production or selling of tangible personal property is apportioned by using a three-factor apportionment formula with a double weighted sales factor. This implies that sales are weighted 50 percent and property and payroll are weighted 25 percent each. The apportionment formula can be written as

¹⁸OCGA § 48-7-30.

¹⁹OCGA § 48-7-31.

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$$\text{Georgia Apportionment Factor} = .25 * \%Property + .25 * \%Wages \\ + .5 * \%Sales$$

where %Property represent the percentage of property owned by a company that is located in Georgia, %Wages is the percentage of a company's total wages and salaries paid to employees located in Georgia, and the %Sales represents the percentage of total sales of the corporation that occur in Georgia.

It is easy to see that the weights on the various factors can influence the amount of income apportioned to Georgia. For example, if the taxpayer corporation did no business outside the state of Georgia, then the apportionment factor would be 100 percent (as each of the three factors would be 100 percent) and the corporation would apportion all of its income to Georgia. Similarly, if a company operated nationwide and had, say, 1 percent of its property, 1 percent of its employees, and 1 percent of its sales in Georgia, it would apportion only 1 percent of its income to the state of Georgia.

In 1995, Georgia changed from an equal weighted apportionment factor formula (33 percent on wages, property, and sales, respectively) to a double weighted approach with the idea that it would benefit those companies with relatively large percentages of company payroll and relatively large percentages of company property located in Georgia. To see how this would work, suppose we have a company with 75 percent of its wages and salaries located in Georgia as well as 75 percent of its property located in Georgia. Additionally, let us assume that 25 percent of its sales are in Georgia. In the case of equal weighted apportionment, the Georgia apportionment factor would be 0.5775 while the double weighted apportionment factor would be 0.38. Thus, by moving from an equal weighted apportionment formula to one with double weights on sales, the company is required to apportion 19.75 percent (=57.75 percent-38 percent) less profits to Georgia.²⁰

²⁰If the taxpayer owns no property then the apportionment formula is $0.33 * \%Wages + 0.67 * \%Sales$. A similar adjustment is made if the company has no employees. Alternatively if the firm has sales, then the apportionment factor is $.5 * \%Property + .5 * \%Wages$. See Rule 560-7-7.03(d) of the Administrative Rules and Regulations of the State of Georgia.

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There is also provision for the Commissioner of the Department of Revenue to allow a different allocation formula if the apportionment does not fairly represent the extent of the taxpayer's activity within the state.²¹ Further, under a Georgia law effective in 1998, the Commissioner of Revenue has the authority to determine whether a change in apportionment may be allowed for legitimate economic development needs. The law allows the Revenue Commissioner to enter into agreements with a taxpayer to change the apportionment rules for a limited time. The statute contemplates an economic development rationale for this exception to the normal apportionment rules. Thus, apportionment rules may be altered under this section only if the taxpayer is planning a new facility or expanding a current facility in the state. In addition, the Revenue Commissioner must believe the new facilities will bring substantial economic benefit to the region where the project is located and that the benefits of the project outweigh the costs to the public.²²

The service sector of the economy also presents some special problems for apportionment. Historically service providers were local business and the traditional three factor formula would capture the economic activity of the service provider as the business was likely to be conducted entirely within the state. For example, mutual funds, airlines, or banks may balk at a traditional three factor formula since the formula may not reflect the economic activity of the firm within the state. With services being provided across state lines, the question arises as to where the sale actually took place. A sale could be in the producer's state or it could be in the customer's state of residence. Without guidance a firm may choose an apportionment formula to minimize its state tax liability.

²¹See § O.C.G.A. 48-7-31(e) and see Rule 560-7-7.03(e) of the Administrative Rules and Regulations of the State of Georgia.

²²OCGA § 48-7-31.1. The Revenue Commissioner when presented with a Freedom of Information Act request by a newspaper would not disclose the companies with approved apportionment formulas due to taxpayer privacy restrictions. However, the Georgia legislature enacted law in 2002 allowing disclosure OCGA § 48-7-31.1(3)(B)(b). See also, Meredith Jordan, "State Reveals Companies that Got Tax Breaks," *Atlanta Business Chronicle*, May 3, 2002 (<http://atlanta.bizjournals.com/atlanta/stories/2002/05/06/story3.html>).

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No general formula has been designed specifically for the service sector, but there are explicit apportionment formulas for airlines²³ and credit card processors.²⁴ These explicit formulas attempt to apportion income to the state based on economic activity within Georgia. However, like all firms there is the potential for a service firm to ask the revenue commissioner for permission to use a formula that will apportion profits more equitably to Georgia. This may be more of an issue as the economy becomes more oriented towards the service sector. If a service provider can determine its own equitable apportionment, it will do so to minimize its own tax liability. This could become an issue of inequitable treatment between manufacturing and service firms, which could then cause a potential revenue loss to the state. However, the administrative rules suggest the demand for a different apportionment formula be employed in “limited and specific cases” where there are unusual fact situations that will be unique and nonrecurring. Further, the permission is granted only for one year.²⁵

Credits: The state provides a number of credits for corporate taxpayers. These credits are a recent phenomenon and most the credits have been enacted in the last ten years. Credits are allowed for certain types of business enterprises consisting of manufacturing, warehousing, processing, telecommunications, tourism, or research and development industries and include the following credits:

Job Tax Credit – Business Expansion and Support Act (BEST) credits are available for qualified expenditures made in Georgia. The value of the BEST credit to the taxpayer differs depending on the location of the employment. Since the BEST

²³OCGA § 48-7-31(2.1)(B) states that air lines must use a 3 factor formula based upon revenue producing air miles in Georgia relative to the rest of the country, tons of property shipped from Georgia, and originating revenue factor which is the percentage of the total passenger and cargo revenue attributable to Georgia divided by the total revenue from cargo and passenger operations everywhere else. Like the general manufacturing approach the apportionment formula is based on 25 percent of the air revenue factor, 25 percent of the tons of cargo factor, and 50 percent the passenger and cargo revenue.

²⁴OCGA § 48-7-31(2.2). If more than 60 percent of total gross receipts comes from credit card processing services, then the apportionment formula is based upon the portion of credit card processing fees earned in Georgia. This single factor apportionment formula is available to those credit card processors with a principal office in Georgia or if their principal customer is in Georgia.

²⁵Rules and Regulations of the State of Georgia 560-7-7.03(8)e(1)-(2).

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program was designed with economic development in mind, larger credits are given to jobs created in less developed counties. Each year the Commissioner of Community Affairs must rank each of Georgia's counties based upon the unemployment rate, the per capita income, and the percentage of persons within the county that are below poverty level. Each of these socioeconomic factors is weighted equally. Counties ranking between 1 and 71 are designated tier 1 counties, counties ranked between 72 and 106 are classified as tier 2 counties, those counties ranked 107-141 are tier 3 counties, and the remaining 18 are classified as tier 4.²⁶

Businesses are permitted a credit of \$3,500 per job per year up to five years if a job is created in a tier 1 county. If a job is created in a tier 2 county the jobs credit is \$2,500 while if the job is created in a tier 3 county, the credit is \$1,250. Finally the job credit in a tier 4 county is \$750.

In order for the taxpayer to be eligible for the credit there are a number of conditions to be satisfied. The first is based upon the number of jobs created. In a tier 1 county, if the taxpayer desires to take the job credit it must create at least five jobs. For tier 2 counties the taxpayer must create 10, while those in tier 3 counties must create 15 new jobs. Finally, those in tier 4 counties must create 25 new jobs to be able to take the credit.

Second, the average wage of the new jobs created must be above the average wage of the county with the lowest average wage. Finally, each job created must have health insurance as a benefit option, although the law does not require that the employer pay any part of the health insurance coverage.

These credits are good for five years starting in the year after the year the job is created. In addition, they can be carried forward for up to ten years. However, any credit taken in a given year cannot be greater than 50 percent of the taxpayer's liability for that year for those placing jobs in tier 3 or tier 4 counties. For taxpayers creating jobs in tier 1 and tier 2 counties, the credit cannot be more than 100 percent of the taxpayer's liability.

²⁶OCGA §48-7-40.

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A job credit similar to that available in tier 1 counties is available to businesses that place jobs in certain blocks of census tracts certified by the Commissioner of Community Affairs as “having undergone a sudden and severe period of economic distress caused by the closing of one or more businesses in the area” or if a business is being bought out for airport expansion, or the closing of a business in this area which would result in a sudden and severe period of economic distress.²⁷

Investment Tax Credit - A credit against income tax otherwise due is authorized for qualified investment property purchased or acquired for use in construction or expansion of manufacturing or manufacturing support facilities. Subject to specific conditions and limitations, the allowable credit ranges from 1 percent to 5 percent of the cost of such qualified property with the higher credit amounts and the lower threshold investment requirements applying in Georgia's less developed areas. The range of credits is 3 percent to 8 percent for qualifying recycling and pollution control property investments. Further, the credit cannot be applied to greater than 50 percent of the taxpayer's tax liability for the year.

Optional Investment Tax Credit – This credit can be taken in lieu of the above investment tax credit each year for up to 10 years if the qualifying property remains in service for that period. This optional credit is calculated based upon a three-year average tax liability and is the lesser of (1) 90 percent of the increase in tax liability in the current year over that in a base year; or (2) the excess of the aggregate amount of the credit allowed over the sum of the amounts of the credit already used in the years following the base year.²⁸

Alternative Fuels Credit - This credit is available to those who purchase or lease alternative fuel (low or zero emission) vehicles. The credit is available for \$2,500 for the purchase or lease of a low emissions vehicle and \$5,000 for a zero emissions vehicle.²⁹

²⁷OCGA § 48-7-40.1.

²⁸OCGA § 48-7-40.7 -40.9.

²⁹OCGA § 48-7-40.16.

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Water Conservation Facilities Credit - Credits are allowed for taxpayers who participate in qualified water conservation investment in Georgia. The investment must meet minimum standards and the credits range from 5 percent to 10 percent depending upon the size of the investment in such qualified property. The credit cannot exceed 50 percent of the taxpayer's tax liability for the year and the credit can be carried forward for ten years.³⁰ Similar credits are provided for taxpayers investing in qualified property designed to reduce ground water usage.³¹

Retraining Tax Credit – Credits allow eligible employers to claim retraining costs to train employees to use new equipment or technology. The credit can be worth 50 percent of the direct costs of retraining full time employees up to \$500 per year per employee for qualified training programs. The credit cannot be greater than 50 percent of the company's corporate income tax liability for a given tax year. Unused credits can be carried forward for up to 10 years.³²

Basic Skills Education Credit - Employers can obtain a credit when they provide or sponsor basic skills education for high school level coursework and/or for coursework leading to a GED. The credit is equal to one-third of the costs of the program up to \$150 per student. The total credits taken in a given year cannot be greater than the taxpayer's tax liability for that year.³³

Child Care Credits – Employers sponsoring childcare for employees are credited with up to 75 percent of the direct costs of the program. The credit, like most other credits, is limited to 50 percent of the taxpayer's current year tax liability. Further, the taxpayer can obtain a credit for 100 percent of any property purchased for childcare services. This property credit is allowable at a 10 percent rate for 10 years.³⁴

Research Tax Credit - Credits are allowed for research expense undertaken within Georgia for any business or headquarters of any business engaged in

³⁰OCGA § 48-7-40.11. An anonymous source at the Georgia Department of Revenue believes that that no corporation has taken this credit.

³¹OCGA § 48-7-40.10.

³²OCGA § 48-7-40.5.

³³OCGA § 48-7-41.

³⁴OCGA § 48-7-40.6.

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manufacturing, warehousing and distribution, processing, telecommunications, tourism, or research and development. The credit is 10 percent over a “base amount” that is a function of the research expenses averaged as a percentage of taxable income for the last three years. The credit can be carried forward for a period of 10 years and may not amount to over 50 percent of the taxpayer’s tax liability in any given year.³⁵

Small Business Growth Companies Tax Credit - This credit is for small business (less than \$1.5 million in tax liability) and is available for business or headquarters of any business engaged in manufacturing, warehousing and distribution, processing, telecommunications, tourism, or research and development that experiences a growth of its net state taxable income greater than 20 percent over the previous year in each of the last three years. The credit is the excess over the 20 percent growth in net taxable income and may not exceed 50 percent of the taxpayer’s current year tax liability.³⁶

Ports Activity Job and Investment Credits - These credits are available to companies that increase their port tonnage through a Georgia ports. The companies must increase their traffic by more than 10 percent over a base defined by 1997 traffic. These credits are combined with the BEST Jobs Credit, the Investment Tax Credit, and the Optional Investment Credit. Thus, if companies are eligible for the credit they can take an additional \$1,250 per job created, or 5 percent investment tax credit, or a 10 percent optional tax credit. Further, if companies create more than 400 jobs, invest \$20 million or more in new or expanded facilities, and increase their traffic by more than 20 percent, they can take both the job tax credit and the investment tax credit.³⁷

Low Income Housing Tax Credit - This credit is available for taxpayers owning housing developments receiving the Federal Low Income Housing Tax Credit. The credit available for the property owner is the value of the Federal credit.³⁸

³⁵ OCGA § 48-7-40.12.

³⁶ OCGA § 48-7-40.13.

³⁷ OCGA § 48-7-40.15.

³⁸ OCGA § 48-7-40.17.

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Headquarters Tax Credit - This credit is available for companies establishing a headquarters in Georgia. To be eligible the companies must create at least 100 headquarters jobs, and spend at least \$1,000,000 in construction or leasing expenses to establish a location for the headquarters. This is a jobs credit so that the jobs, to qualify for the credit, must pay a salary which must be a differential above the county average wage in the county in which it is located. Like the jobs tax credit, the necessary salary differential is smaller in lesser-developed counties. The credit is \$2,500 per job, or \$5,000 if the salary is above 200 percent of the county average wage. In addition, this credit can offset up to 100 percent of a taxpayer's tax liability. If the credit is greater than that, it can be further offset against the corporations monthly or quarterly withholding.³⁹

Finally, as discussed above, financial institutions are allowed credit for local business license and state occupation taxes paid.⁴⁰ These are dollar-for-dollar creditable against the financial institution's insurance tax liability.

Figure 3 shows the value of the total credits over time. As can be seen, the total dollar amount of the credits increases over time, as does the percentage of credits relative to the total corporate income tax collected. The increase in available credits has an effect on the ability of the corporate income tax to raise revenue. This should be kept in mind when we discuss the general erosion of the corporate income tax.

Faulk et al. evaluate many of these credits.⁴¹ Their conclusions regarding the jobs credits are interesting. First, only a fraction of the jobs created (29 percent) were actually created as a result of the BEST Credits. In addition, participation is low due to lack of information about the credit, the high administrative burden and because many firms have little tax liability. Finally, while the largest benefits of the credit were designed to provide incentives for companies to locate jobs in less developed

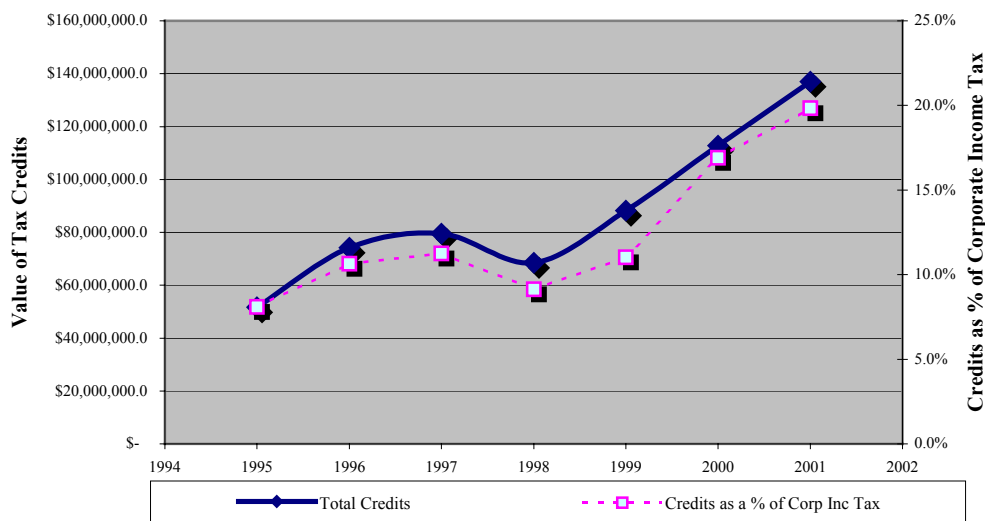
³⁹OCGA § 48-7-40.17.

⁴⁰OCGA § 48-7-93(e).

⁴¹ Dagny Faulk, Keith R. Ihlanfeldt, David L. Sjoquist, William Smith, Jeanie Thomas, and Kathleen Thomas, *An Analysis of Georgia's Economic Development Tax Credit Incentives*, [Fiscal Research Program Report No. 42](#) (January 2000).

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FIGURE 3. GEORGIA BUSINESS TAX CREDITS, 1995-2001



Source: Kelly Edmiston, Fiscal Research Program, based on data provided by the Georgia Department of Revenue.

areas of the state nearly half of the jobs were created in the most developed counties in the state. Thus, there is evidence that the credits are not going to those areas where the need is arguably most critical. In addition, the jobs credits by themselves have increased as a percentage of the total tax credits from 10 percent in 1995 to 21 percent in 2001.

Economic development is important to Georgia and the southeastern states. Table 4 shows a comparison of tax incentives for a number of southeastern states. Georgia, as mentioned above, has a jobs credit and a credit for business investment in certain enterprise zones. Other states have enacted jobs creation credits where a given minimum number of jobs must be created as a requirement for obtaining the credit. Others states have also added a development aspect by requiring the jobs be combined with an investment and/or requiring the jobs be created in less developed areas of the state. The southeastern states appear to be quite competitive in offering

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TABLE 4. PRESENCE OF CORPORATE INCOME TAX CREDITS IN THE SOUTHEASTERN U.S.

State	Jobs Credit	Investment Credit	Enterprise Zone Credit
Alabama	Yes if at least 20 jobs created + minimum investment	Yes	
Arkansas	Yes and credit increases for jobs in disadvantaged areas		Yes
Florida	Yes if at least 10 jobs are created		
Georgia	Yes if at least 5 jobs are created and credit increases for jobs in disadvantaged areas	Yes	Yes
Kentucky	Yes if at least 25 jobs are created		Yes
Louisiana	Yes, but ends in 2002		Yes
Mississippi	Yes		Yes
North Carolina	Yes if at least 5 jobs created	Yes	Yes
South Carolina	Yes if at least 10 jobs created	Yes	Yes
Tennessee	Yes if at least 25 jobs created + minimum investment	Yes	Yes
Virginia	Yes if 50 jobs created		Yes

SOURCES: Multistate Tax Guide, 2001, J. Thomas, *State Economic Development Incentives in the Southeast*, Fiscal Research Program Report 40, Summary Table p.4 (1999), and state economic development websites.

economic development incentives based on credits to the income tax.⁴² What is important to note is that while Georgia's tax credits are potentially expensive in terms of lost tax revenue, they may be needed to keep Georgia competitive with other states.

⁴²See Multistate Tax Guide, 2001, pp 681-706. Also see Jeanie Thomas, *State Economic Development Incentives in the Southeast*, [Fiscal Research Program Report 40](#), (1999) for an over view of economic development activities in the southeast.

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4. Structure of the Tax by Taxable Income

Table 5 shows the distribution of income taxes paid by taxable income for fiscal year 2000. The largest firms in terms of taxable income, those with taxable income over \$1 million accounted for 1.29 percent of the returns, and pay approximately 80.38 percent of the corporate income tax. The next highest group of taxpayers, those with incomes of \$500,000 to \$1 million, contributed 6.38 percent of the total tax collected while accounting for 0.89 percent of the taxpayers. It should be noted that a super majority (74.19 percent) of returns had no income tax liability.

TABLE 5. DISTRIBUTION OF TAXABLE INCOME, FISCAL YEAR 2000

	N	Percent of Returns	Net Taxable Income	Percent of Net Taxable Income
\$1-\$5,000	5,686	6.53	\$10,654,792	0.12
\$5,000-\$10,000	2,258	2.46	\$16,445,509	0.18
\$10,000-\$25,000	3,859	4.21	\$64,275,550	0.71
\$25,000-\$50,000	3,266	3.56	\$118,227,242	1.31
\$50,000-\$100,000	2,768	3.02	\$196,357,515	2.17
\$100,000-\$250,000	2,304	2.51	\$364,206,799	4.02
\$250,000-\$500,000	1,213	1.32	\$428,984,309	4.74
\$500,000-\$1,000,000	819	0.89	\$577,380,152	6.38
over \$1,000,000	1,184	1.29	\$7,276,607,754	80.38
None	68,013	74.19	---	0.00
	91,670		\$9,053,139,622	

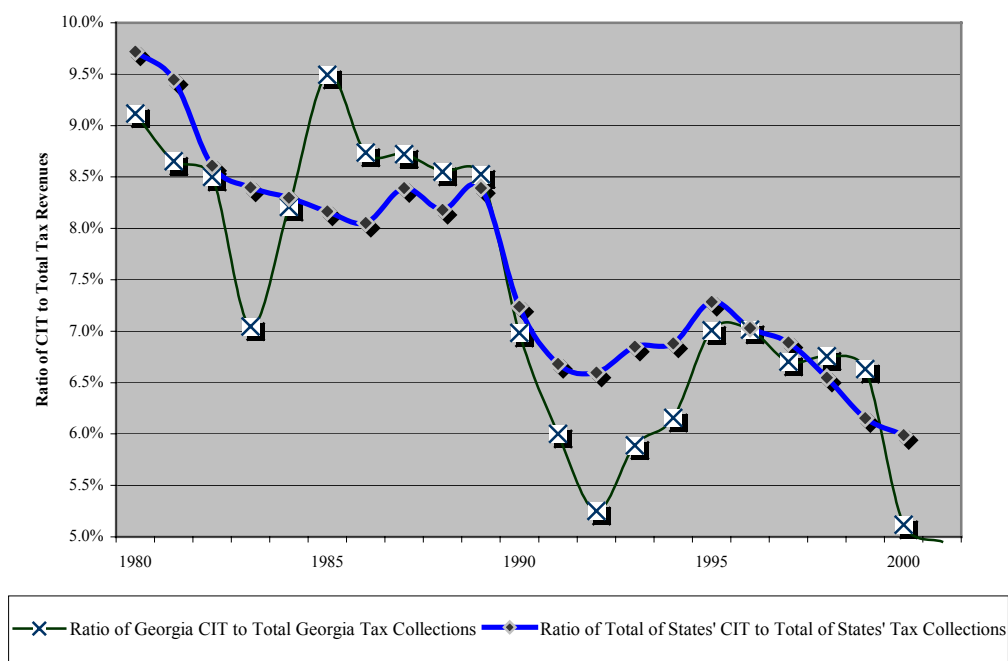
SOURCE: Georgia Department of Revenue Report, 2001.

5. The Decreasing Importance of the Corporate Income Tax

The volatility in tax revenues of Georgia's company taxes from 1990 to 2001 (Figure 1 and Figure 2), and the general decrease in importance of the corporate franchise tax in the total tax revenues mirror the experience of all other states in the same period. This can be seen quite clearly in Figure 4 which presents the trend in the ratio of corporate income tax to total tax collections in Georgia for the same ratio all states. Table 6 illustrates the trend in this ratio for other Southeastern states. For each state has seen the corporate income tax become less important as a percentage of total tax receipts.

Georgia's Corporate Income and Net Worth Taxes

FIGURE 4. COMPARISON OF THE RATIO OF CIT TO TOTAL TAX REVENUES FOR GEORGIA AND THE U.S., 1979-2001



Source: Georgia Department of Revenue and U.S. Bureau of the Census

TABLE 6. PERCENTAGE OF STATE TAX REVENUES FROM CORPORATE INCOME TAX, SOUTHEAST, 1979, 1989, AND 2000

	1979	1989	2000
Alabama	5.8%	5.9%	3.8%
Arkansas	8.4%	5.1%	4.9%
Florida	7.3%	5.8%	4.8%
Georgia	9.2%	8.3%	5.3%
Kentucky	7.9%	7.6%	4.0%
Louisiana	9.7%	8.7%	3.4%
Mississippi	4.9%	6.3%	4.8%
North Carolina	8.7%	10.7%	6.5%
South Carolina	9.2%	5.9%	3.6%
Tennessee	10.1%	9.1%	7.9%
Virginia	7.7%	5.2%	4.5%

SOURCE: Bureau of the Census, State and Local Government finances

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What explains the declining relative importance of Georgia's corporate income tax? To answer this we need to examine causes for the relative decline in revenues outside the control of the state, or, differently put, causes for the decline in revenues that are shared with other states. Georgia's experience with a continuing decrease in importance of the corporate franchise tax does not differ much from that of other states with a corporate income tax, or indeed from the experience of the corporate income tax at the federal level.⁴³

At the federal level, collections from the corporate income tax have been declining since the 1960s when the corporate income tax represented as much as one-fifth of federal total tax revenues. Since the mid 1980s, corporate income tax collections have represented approximately one-tenth of federal total tax revenues. Part of this decline is associated with policy changes granting more favorable tax treatment to corporations. This started with the investment tax credits of the 1960s and culminated with the Accelerated Cost Recovery Act of 1981. The Tax Reform Act (TRA) of 1986 was, in part, an attempt to turn around the declining revenues from the corporate income tax by taking away many of the tax advantages granted in the past, by reducing capital depreciation allowances, and by introducing an alternative minimum tax.

However, there were other offsetting changes in the tax environment since 1986. Perhaps the most important was the number of corporations that elected to organize as S Corporations after the 1986 TRA. The relative growth in the number of S Corporations is commonly identified as a significant source of erosion in corporate tax revenues.⁴⁴

Under the Internal Revenue Code, small, closely held companies can elect to be treated differently than traditional, or "Chapter C Corporations." By electing to be taxed as an S Corporation a firm obtains "pass through" (from the corporation to the shareholders) treatment of any profits earned in a tax year. Thus, if a company is

⁴³ See also Sally Wallace, *Trends In Corporate Income Tax Receipts*, [FRP Report No. 52](#) (December 2000) for more details about Georgia's corporate income tax receipts over time.

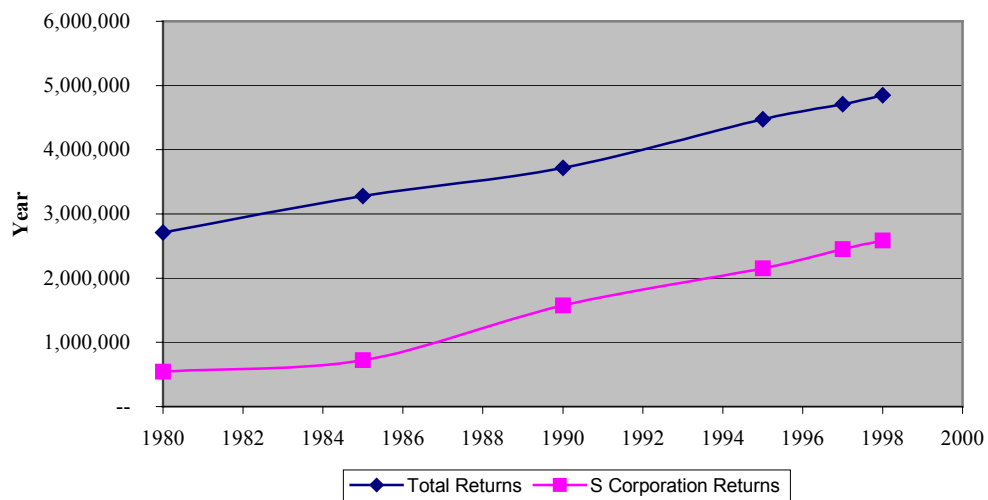
⁴⁴ See e.g. Susan Wittman, "S Corporation Returns," *Statistics of Income Bulletin*, (Spring 2001): 48-101.

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eligible for an S Corporation election, it need not pay any Federal corporate income tax. Essentially, the company grants a dividend to its shareholders and they, in turn, would pay individual income tax on the dividend. This avoids the normal double taxation of profits that occurs through corporate taxation. Many states, including Georgia, treat S Corporations in the same manner.⁴⁵

S Corporations are becoming more important as a form of doing business. Figure 5 shows the total and S Corporation returns for 1980-1998 (the latest year available). In 1980, the S Corporations constituted 21 percent of corporate returns. By 1998, S Corporations -constituted about 53 percent of all federal income tax returns.

FIGURE 5. TOTAL AND S CORPORATION FILINGS, 1980-1998



Source: IRS Statistics of Income, 1998.

⁴⁵However, S corporations do face a number of restrictions that do not affect C corporations. S corporations can not have more than 75 shareholders, they can issue only one type of stock, they must be a domestic corporation (US), and they may not be part of an affiliated group.

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Over this period the percentage of net income earned by S corporations also rose. In 1986, the net income earned by S Corporations was 5.9 percent of total corporate earnings, and by 1998 it amounted to 14.9 percent. Similarly, assets held by S Corporations in 1980 accounted for only 1.9 percent of corporation assets, but by 1998 they had almost 38 percent of corporate assets.⁴⁶

Table 7 shows that Georgia has experienced a similar trend in its S Corporation filings. Over the periods 1993 to 1997 we saw the percentage of S corporation filings increase from 50.42 percent to 57.28 percent. Furthermore, Georgia S Corporations represent a substantial percentage of net worth of the companies taxable in Georgia.⁴⁷ What makes the Georgia experience different from the federal experiences is that the percentage of net worth coming from S Corporations is relatively high in Georgia and at the same time also appears to be more volatile.

TABLE 7. GEORGIA "S CORP" AND "C CORP" FILINGS, 1993-1997

Tax Year	C Corp Filings	S Corp Filings	S Corps as Percent of Total Filings	S Corp Net Worth as Percent of Total Net Worth
1993	56,503	57,460	50.42%	43.95%
1994	60,180	63,715	51.43%	81.18%
1995	63,073	70,631	52.83%	10.27%
1996	65,097	78,401	54.64%	59.41%
1997	63,505	85,157	57.28%	66.02%

SOURCE: Georgia Corporate Income Tax Database

Not all the decrease in revenues from corporate income taxes can be traced to changes in tax policies and the rise of S Corporations. It appears that there has also been a persistent downward trend in the relative importance in the base of the

⁴⁶See Robert Carrol and David Joulfain, "Do Taxes Affect Corporate Financial Decisions? The choice of Organizational Form," mimeo, Office of Tax Analysis, U.S. Department of the Treasury, 1993.

⁴⁷Using the net worth component of the income tax (discussed below) it is possible to determine the amount of taxable net worth allocated to Georgia. S Corporation net worth as a percentage of total net worth is calculated as the Georgia Net worth of the S Corporation divided by the sum of the S corporation net worth and the C corporation net worth.

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corporate income tax predating the Tax Reform Act of 1986. Auerbach and Poterba,⁴⁸ who have studied the long-term decline in federal corporate income tax revenues, find that while the average tax rate of corporate taxation had fallen by one-third from the mid 1960s to the mid 1980s, corporate profitability had declined by a factor of two in the same period. While it has been relatively easy to untangle the causes behind lower average corporate tax rates, to date there is no clear understanding of why corporate profitability has decreased so much. The profit rate had a downward trend since the 1960s and dropped most sharply in the 1980s.⁴⁹ Many observers associate this sharp decrease with the oil crisis that occurred about the same time. In more recent years, the rate of profitability has turned around but it has not reached the levels of the 1960s or early 1970s, except for the temporary boom from the e-commerce bubble.

In addition to decreases in corporate profitability, there is more sophisticated tax planning at both the state and federal level. First, one of the more important tax issues facing the Treasury and Congress is the alleged growth of corporate tax shelters. The use of tax shelters, while seemingly innocuous, may have implications for the collection of the corporate income tax at the federal level and at the state level if the state takes its definition of income from the federal tax form. One of the major problems with corporate shelters is that the scope of the problem is not well known. It is difficult for the IRS to determine how much income is being lost as a result of the sheltering activity. Since Georgia starts from the Federal Income Tax definition of net taxable income, Georgia should also be concerned about how corporations shelter their income.

The Department of the Treasury issued a report in 1999 detailing the types of tax shelters it has seen and recommendations for the proper legislative treatment.⁵⁰ Yale Law School Professor Michael Graetz defined a tax shelter as “a deal done by

⁴⁸See Alan J. Auerbach and James Poterba, “Why Have Corporate Tax Revenues Declined?” in L. Summers ed., *Tax Policy and the Economy* (MIT Press: Cambridge) 1987.

⁴⁹From an average of 10.9 percent in the 1960s the profit rate fell to 7.2 percent during the 1970s and 4.9 percent during the first half of the 1980s.

⁵⁰U.S. Treasury, Office of Tax Policy, *The Problem of Corporate Tax Shelters: Discussion, Analysis, and Legislative Proposals*, 1999. http://www.taxpolicycenter.org/taxfacts/papers/corp_shelter.pdf.

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very smart people, that absent tax considerations, would be very stupid.”⁵¹ Tax shelters that have no value except their tax benefits also have problems that increase the cost of the shelters to society. First, obviously, is the loss of tax revenue that comes with sheltering taxable income (e.g. legal and accounting fees). Second, is the problem that shelters often come with a high transactions cost.⁵² Thus, the Treasury loses income and society wastes resources sheltering the income. Third, there is generally no offsetting economic benefit. In fact, as Professor Graetz's statement makes clear, there is no economic substance to the transaction.

Finally, society must pay the additional costs of litigation of shelters of near legality (or near illegality) as well as the costs of rewriting tax rules over and over to reduce the likelihood of future abusive shelters. This could be an increasingly futile effort.

As corporations become multinational in scope and operation, there is the opportunity for businesses to reincorporate outside the United States in a tax haven that treats corporations in a more favorable manner. However, this activity is coming under increasing scrutiny with bills in the U.S. House and Senate introduced in early 2002 to attempt to regulate this behavior.⁵³

At the state level there is also a type of tax planning that has states, including Georgia, concerned. This planning involves an offshore jurisdiction or a foreign state such as Nevada or Delaware that has laws to accommodate this particular type of plan. To avoid paying state income tax to Georgia, it is possible to set up a Delaware holding company (or a Nevada holding company) whereby the holding company becomes the owner of intellectual property (e.g., trademarks, copyrights, and patents) of the firm.⁵⁴ The holding company then leases back to the operating company the right to use the intellectual property. Since this licensing fee is a deductible expense,

⁵¹See, Tom Herman, “Tax Report”, *Wall Street Journal*, A-1 (February 10, 1999)

⁵²In one case (*ASA Investing v. Commissioner*, 76 T.C.M. (CCH) 325 (1998)), the transactions cost were 26.5 percent of the purported tax saving of \$93.5 million.

⁵³HR 3384 Corporate Patriot Enforcement Act of 2002 and S. 2119 Reversing the Expatriation of Profits Offshore Act both in the 107th Congress, Second Session.

⁵⁴Delaware exempts from its corporate income tax those companies holding solely intangible assets. Nevada, in turn, does not have a corporate income tax. Thus both states would allow companies to employ tax planning to avoid state income taxes.

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profits are reduced. In fact, the licensing fees may be structured to eliminate a company's tax liability completely.

The states have been aggressive in attempting to litigate to void these arrangements, as the stakes are potentially quite large. In 1990, Toys'RUs earned \$55 million in royalty and license fees by charging the individual stores for the rights to employ the trademarks, the name, and for merchandizing skills.⁵⁵ In another example, Kmart earned some \$125 million in royalty income from 1991-1995 using a similar tactic.⁵⁶ Georgia also has had an experience with this issue. In 1994, the Georgia Court of Appeals upheld a plan by Aaron Rents that employed a Delaware holding company structure to avoid significant amounts of state income taxes.⁵⁷

Given that most states' corporate income tax laws are tied to the federal tax law, it is still important to look at how Georgia compares to other states. The next section will examine the Southeastern states' corporate income tax structures and compare them to Georgia's.

6. Georgia Versus Other Southeastern States

Average Reliance on the Tax: Table 6 showed the ratio of corporate tax collections to total taxes collected. In 2000, Georgia ranked 9th in the Southeast at 5.30 percent. Only North Carolina and Tennessee were more dependent on the tax than Georgia.⁵⁸ Further, Table 8 shows the ratio of the corporate income tax collections to state Gross Domestic Product (GDP) across the southeast. This is a

⁵⁵Geoffrey, Inc. v. South Carolina Tax Commission, State of South Carolina Supreme Court, Opinion No. 23886, July 6, 1993.

⁵⁶*In the Matter of Kmart Properties, Inc.*, New Mexico Taxation and Revenue Department, No. 00-04, Jan 31, 2000. The case further revealed that Kmart's holding company earned an additional \$78 million over the same five-year period by lending its royalty receipts back to Kmart usually within two or three days from when they were received. See Michael Mazerov, "Closing Three Common Loopholes Could Raise Additional Revenue for Many States," Center on Budget and Policy Priorities (April 2002) <http://www.cbpp.org/4-9-02sfp.htm>, *Tax Analyst Reference 2002 STT 82-1*.

⁵⁷*Aaron Rents Inc. v. Marcus E. Collins, Sr.*, No D-96025 (Fulton County Superior Court, June 27, 1994). The Georgia Supreme Court decline to hear this case on appeal on August 24, 1994.

⁵⁸ As with each of the following statistics, one should not focus on one over another, but look at them as a whole. The economies of each of the states, while similar in many respects are not identical: some are more based on manufacturing, others are service oriented, and still others are agricultural.

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TABLE 8. COMPARISON OF THE RATIO OF CORPORATE INCOME TAX COLLECTIONS AS A PERCENTAGE OF STATE GROSS DOMESTIC PRODUCT IN THE SOUTHEASTERN US, 1999

State	Ratio of CIT to GSP	Rank in SE
Virginia	0.171%	1
Alabama	0.203%	2
Louisiana	0.222%	3
South Carolina	0.241%	4
Kentucky	0.275%	5
Florida	0.286%	6
Georgia	0.288%	7
Arkansas	0.328%	8
Tennessee	0.336%	9
North Carolina	0.356%	10
Mississippi	0.357%	11
US Average	0.330%	

SOURCE: Bureau of the Census and Bureau of Economic Analysis

gross indication of how intensively the state taxes its state product. Georgia is ranked 7th out of the 11 states.

Tax rate and tax base: Georgia has a corporate income tax structure that is typical in the South. With respect to tax rates, Georgia's rate of 6 percent is on the upper end of the range of the southeastern states (see Table 9). Tennessee and Virginia have the same rate of 6 percent. Florida, Alabama and South Carolina have lower rates, while North Carolina and West Virginia have higher rates. Several other states use a progressive schedule, generally with a top rate over 6 percent. Figure 6 shows the marginal tax rates for a number of southeastern states and shows that after \$1,000,000 of taxable income, Georgia is below only Louisiana, Kentucky, and North Carolina. Thus, Georgia's marginal tax rate of 6 percent is among the highest in the southeast for large profitable firms.

With respect to the tax base, Georgia couples the state tax to the federal tax with taxable income after special deductions in the federal tax, as do most other states in the Southeast. However, North Carolina, Tennessee and Louisiana start with taxable income before these special deductions. Georgia allows for 3-year carry back

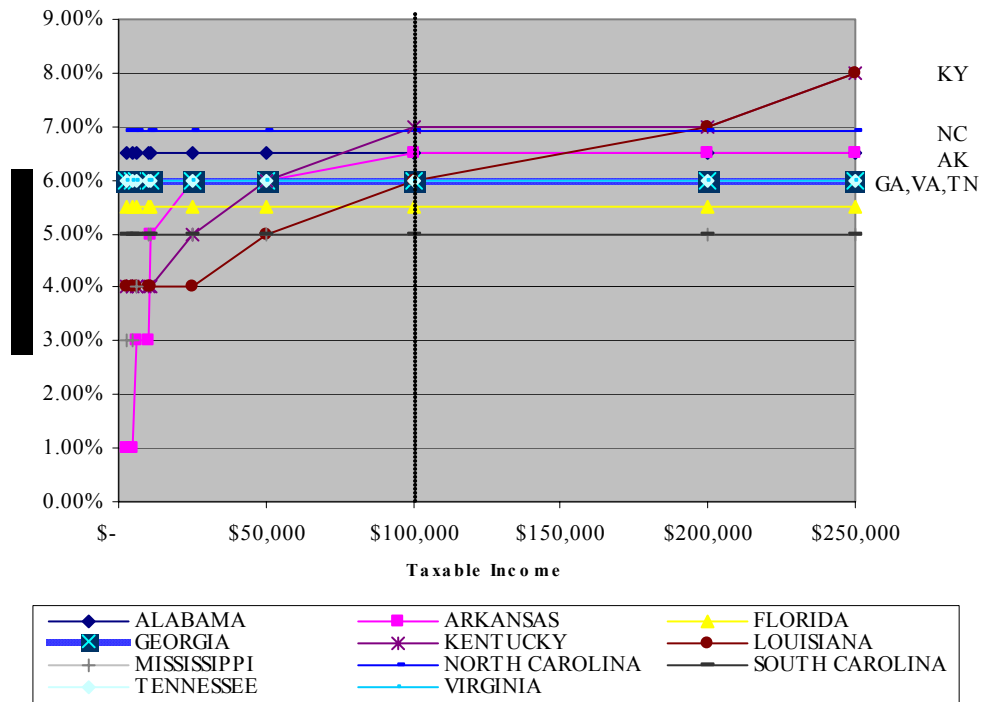
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**TABLE 9. COMPARISON OF CORPORATE TAX RATE ACROSS
SOUTHEASTERN US, 2000**

State	Tax Rates in Percent	Tax Brackets	Number of Brackets
Alabama	5	---Flat Rate---	1
Arkansas	1.0-6.5	3,000 100,000	6
Florida	5.5	---Flat Rate---	1
Georgia	6	---Flat Rate---	1
Kentucky	4.0-8.25	25,000 250,000	5
Louisiana	4.0-8.0	25,000 200,000	5
Mississippi	3.0-5.0	5,000 10,000	3
North Carolina	7.25	---Flat Rate---	1
South Carolina	5	---Flat Rate---	1
Tennessee	6	---Flat Rate---	1
Virginia	6	---Flat Rate---	1

SOURCE: Federation of Tax Administrators, <http://www.taxadmin.org>.

FIGURE 6. SOUTHEASTERN MARGINAL TAX RATES, 2001



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of net operating losses (NOLs) and a 15-year period for losses carried forward. Half of the states in the South do not allow the carry back of losses. Georgia, like most southern states, exempts interest earned on U.S. securities;⁵⁹ only Florida and Tennessee tax it.⁶⁰

Conclusions: The corporate income tax is not a stable source of income as it is subject to business cycle fluctuations. Georgia seems to rely more on the corporate income tax as a percentage of total tax receipts than most of the other states in the Southeast. As a percentage of state GDP, Georgia is also one of the highest in the southeast in terms of its demand on state product. In addition, its tax rate is among the highest in the Southeast. Finally, because Georgia's tax collections from the corporate income tax is influenced by the Federal tax law, its own use of credits, the growth of S Chapter Corporations, and the growth of state tax planning, the amount collected in the future will most likely continue to decline as a percentage of total tax receipts.

B. Net Worth Tax

The net worth tax in Georgia is a tax placed on the net worth of the corporation, which includes issued capital stock, paid-in-surplus, and earned surplus.⁶¹ Essentially this tax is on the value of the equity of the firm. Capital stock is the value of the corporation's preferred or common stock, while paid-in-surplus is defined as the price paid by investors per share over the par value per share, times the number of shares issued. Finally, earned surplus is merely the retained earnings of the firm. Together these account for the net worth (or equity value) of the firm. The tax is graduated starting at \$10 for companies with net worth less than \$10,000 and rising to \$5,000 for companies with over \$22,000,000 in net worth.

For foreign corporations (non-Georgia) there is a procedure to allocate a portion of the company's net worth to Georgia. The allocation is based on the sum of

⁵⁹The U.S. Supreme court requires states to tax U.S. Securities in a manner consistent with a state's taxation of its own securities. See, OCGA § 48-7-27b(1)A - b(1)13.

⁶⁰ See e.g. *Multistate Corporate Tax Guide 2001* (Vol I): 419-422.

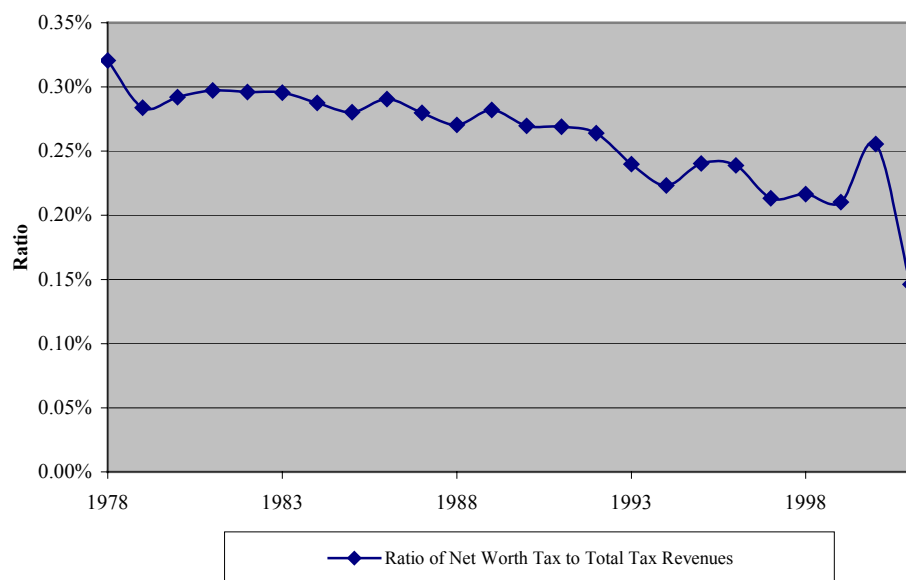
⁶¹OCGA § 48-13-73.

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the value of property located in Georgia and gross receipts in Georgia relative to everywhere else.⁶²

Historically, tax collections from the net worth tax follow the general economic cycle, increasing in years of general economic growth and decreasing during a recession (recall Figure 3). In real terms (using 1984 as the base year) the net worth tax has barely increased, going from just over \$10 million in 1978 to approximately \$11 million in 2001. While somewhat cyclical in nature, its importance to Georgia has diminished as the ratio of the net worth tax to total taxes has fallen from 0.33 percent in 1978 to approximately 0.15 percent in 2001 (Figure 7).

FIGURE 7. RATIO OF NET WORTH TAX TO TOTAL TAX REVENUES



Source: Georgia Department of Revenue, Annual Report (various years).

⁶²OCGA § 48-13-75.

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The current revenue from the net worth tax to the state is minimal. However, the tax does act as a minimum tax on companies doing business in Georgia. Further, it is applied to all corporations, so insurance companies and S corporations pay this tax as well. As currently structured, the net worth tax is not an effective alternative minimum tax since its highest level is only \$5,000, but it could be altered to suit that need if desired.

C. General Issues and Options for Reform

There are a number of specific topics relative to Georgia's corporation taxes worthy of further discussion. These include changes in nexus (the right of the state to tax income), changes in the apportionment formula, the use of separate versus combined reporting; the development of an alternative minimum tax (AMT), and the potential for scrapping the current tax scheme for a value added tax. The next sections discuss each of these potential changes.

I. *Nexus*

Nexus is defined as the minimum (legal or constitutional) connection necessary to give the state the right to tax a business. For example, if there was a firm doing business outside the state of Georgia with no connection whatsoever to the state, Georgia would not be constitutionally permitted to tax that business. Further, the Supreme Court has held that an out-of-state mail order business could not be taxed if all it did was mail goods to the state. If there were no employees within the state, no sales agents, no property, no advertising or connection other than the mail order sale, the Court held that general due process (or fairness) would prohibit the state from imposing a sales tax on out-of-state-activities.⁶³ Even though this example is based on the sale and use tax it is illustrative of the basic problem of interstate taxation. In order to legally tax activities within a state, there must be some type of connection, or nexus, to the taxing state. Generally, nexus is established through

⁶³*Quill v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904 (1992). In this case the Supreme court overturned a North Dakota Supreme Court opinion which allowed the taxation of an Illinois office supply mail order companies sales in North Dakota. The Illinois company had no agents, property, employees, or other contact with North Dakota. Thus, without a physical presence in the state, North Dakota would not be able to tax these sales.

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property owned, sales solicited through agents, employees operating in state, or advertising in state.

Each state has a slightly different definition of what constitutes nexus; some are conservative and some are broad. Georgia's definition of nexus includes all activities for financial profit or gain.⁶⁴ Georgia's definition and its administrative implementation do not appear overly broad by national standards.⁶⁵ For example, Georgia does not consider the licensing of software or intangible rights or simply listing a company name in a phone book as activities creating income tax nexus, as other states do. On the other hand, Georgia is more likely to consider that nexus results from in-state sales activities than many other states.

What is apparently missing in Georgia, and in a number of other states, is a new standard for e-commerce activities. Just as a simple example, suppose a company in Florida contracts with a company in Georgia to host a website on computers physically located in Georgia. If the Florida company has no other connection to Georgia, would this contact be sufficient for nexus? This is an example of the types of questions that will need to be answered as technology alters how firms conduct business. Even if Georgia examines these e-commerce activities more closely and attempts to define nexus to cover them, Congress may pre-empt the states from taxing in this area. Congress is currently considering a bill entitled the Internet Tax Fairness Act of 2001.⁶⁶ This bill, if enacted, would prohibit nexus without a physical presence. Specifically excluded from state taxing authority would be nexus based on the following:

- solicitation of orders;
- presence of intangible property or intellectual property within the state;
- presence of a world wide web internet site on a server located within the state;

⁶⁴OCGA § 48-731(a).

⁶⁵See e.g. *Multistate Tax Guide 2001* (Vol. I): 41-122.

⁶⁶Internet Tax Fairness Act of 2001, HR 2526 (107 Congress, 1st Session) http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h2526ih.txt.pdf. The Act has had sub committee hearings in the House Judiciary Committee on September 11, 2001, but has not progressed beyond this stage.

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- use of an internet service provider located within the state;
- leasing or owning of certain property (for less than 30 days) for the purposes of assembly or testing of machinery and equipment for eventual sale or lease to a resident of the state;
- assignment of personnel to the state for a 30 day period or less if the personnel were directly related to the purchasing of goods or services, gathering news and covering events, meeting with government officials, attending conferences, seminars and similar functions;
- use of an independent contractor in a state for the purpose of performing warranty or repair services with respect to tangible or intangible personal property sold by a person located outside the state.

Georgia may benefit from not moving aggressively on e-commerce nexus issues as it may dampen e-commerce activity in the state. In any case, if Congress does move to provide nexus relief for e-commerce activities, Georgia's law would be pre-empted.

2. *Apportionment Formula*

As discussed above, when corporations are involved in businesses in several states, each state employs a formula to apportion the corporation's share of income on which to levy the state corporation tax. Georgia now uses the double weighted sales, three-factor formula. Thus, sales are weighted 50 percent, payroll is weighted 25 percent, and revenues are weighted 25 percent.

Over the past decade more states have made use of modified apportionment formulas. The most common modification is the switch to a double-weighted sales factor in the traditional equally weighted three-factor formula. Several states have also adopted a single factor sales formula that places a 100 percent weighting on sales. The overriding consideration for the adoption of modified formulas, giving more weight to the sales factor, is to encourage the location of manufacturing businesses in the state. On the surface, it appears the heavier weight given to sales in the modified formulas decreases the tax burden of companies with property and payroll in the state while it increases the tax burden for out-of-state companies mostly selling commodities within the state. However, Edmiston has described this effect in a slightly different manner. The benefit from the reweighing of the apportionment formula comes not from a lower tax liability, but a decrease in the implicit excise tax

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on payroll and property within the states. Thus, in effect, it becomes cheaper to own property and employ workers in the state, all other things equal.⁶⁷

Table 10 shows the use of the apportionment formula by southern states. Most states in the southeast employ the double weighted sales formula. Alabama appears to be the only state to still employ the equal weighted three-factor formula. Georgia adopted its formula in 1995 in response to a perception that it needed to do so to remain competitive with other states.

TABLE 10. SOUTHEASTERN STATES' USE OF APPORTIONMENT FORMULAS

Alabama	3 Factor
Arkansas	Double Weighted Sales
Florida	Double Weighted Sales
Georgia	Double Weighted Sales
Kentucky	Double Weighted Sales
Louisiana	Double Weighted Sales
Mississippi	Double Weighted Sales
North Carolina	Double Weighted Sales
South Carolina	Double Weighted Sales
Tennessee	Double Weighted Sales
Virginia	Double Weighted Sales

SOURCE: Federation of Tax Administrators,
http://www.taxadmin.org/fta/rate/corp_app.html

There has been a suggestion that Georgia change its apportionment formula once again. The change would be to use a single factor sales formula, which is used by only a handful of states. The idea behind the single factor approach is to stimulate economic development in Georgia and to shift taxes to out-of-state corporations. This would especially benefit those companies with significant presence in the state, and also have significant sales activity outside the state. Research in the 1980s and 1990s found that changing from an equal weighted approach to a double-weighted sales approach was consistent with increases in economic activity.⁶⁸ However,

⁶⁷ Kelly Edmiston, *The Manipulation of State Corporate Income Tax Apportionment Formulas as an Economic Development Tool*, [FRP Report No. 26](#) (November 1998) forthcoming *National Tax Journal*.

⁶⁸ Austan Goolsbee and Edward L. Maydew, *Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment*, *Journal of Public Economics*, 75 (January 2000): 833-839.

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Edmiston has shown that the movement to a heavier weighted sales factor may have a differential effect, as there will be some winners and some losers in a move to a new apportionment formula.⁶⁹ Further, while examining the question of whether Georgia would benefit from a single factor sales apportionment formula, he finds that while a single factor approach would likely stimulate economic development in the state to some degree, there will be a reduction in the growth rate of corporate income tax revenues that would last many years.⁷⁰

3. *Income Reporting: Separate Accounting vs. Unitary Approach*

Georgia uses separate income accounting -- the detailed allocation of receipts and expenditures to each separate legal entity -- when considering the income of integrated corporations. Thus, if there are two related corporations doing business within and outside the state, the Georgia statute allows each of the legal entities to report their separate accounts and profits.⁷¹ Georgia is not out of line with other states on this issue, but there may be compelling reasons to change to a unitary system of reporting.

The main difficulty with separate accounting reporting is that it allows corporations to employ strategies to reduce the state tax liability in an artificial and, potentially, inequitable way. Under separate income accounting, corporations have a strong incentive (and are allowed) to shift profits to those states that will tax profits more lightly or that do not tax them at all. The shifting of profits across state lines is easily accomplished by using internal transfer pricing arrangements or by establishing shell passive-income companies in states, such as Delaware, that exempt this type of income. As discussed above, the Delaware holding company is given the property right to the use of the name of the parent company, and at the same time the parent company leases back the right to use the name in exchange for a share of the sales proceeds from its associated companies. *Aaron Rents*, a case decided in Fulton

⁶⁹Kelly Edmiston, *The Manipulation of State Corporate Income Tax Apportionment Formulas as an Economic Development Tool*, [FRP Report No. 26](#) (November 1998) forthcoming *National Tax Journal* (2002).

⁷⁰Kelly Edmiston, *A Single Factor Sale Apportionment for the State of Georgia*, [FRP Report No. 55](#) (January 2001).

⁷¹OCGA § 48-7-34.

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County in 1994, upheld a Georgia company's ability to reduce its tax liability in Georgia by 90 percent after establishing a Delaware holding company.⁷² A similar approach is being used by corporations that set up an investment holding company offshore (in, say, Bermuda) to avoid federal corporate income taxes.⁷³

The most used alternative to the separate accounting reporting method is to put all legally related companies into a unitary business and require that they file a combined income tax return. If we assume the combined income of all related corporations worldwide is in the unitary business, net income is allocated to each subsidiary using an apportionment formula. The impact of this approach is that it destroys any possibility of using strategies to reduce the state taxable income by any particular corporation.

Strictly on economic and tax enforcement merit grounds, all economists would agree that combined reporting is the only way to report income for state tax purposes. Combined income reporting, however, has gained a bad reputation in business circles because of the aggressiveness with which California and other states used it on a worldwide basis. Most of the states using combined income reporting apply it only to the territory of the U.S., following the "water edge" rule.⁷⁴ This results in a more "equitable" tax policy and at the same time reduces incentives to engage in artificial and distortionary tax planning. Because corporations may still shelter off-shore income, there are still incentives to do so. Further, as corporations' international operations increase, the state tax benefits (in terms of revenue raising) from worldwide combined reporting increase.

The adoption of combined income reporting may be considered anti-business and therefore politically unwise. However, two factors should be considered. First,

⁷²*Aaron Rents Inc. v. Marcus E. Collins, Sr.*, No D-96025 (Fulton County Superior Court, June 27, 1994). The Georgia Supreme Court decline to hear this case on appeal on August 24, 1994. Thus, the holding of the trial court was upheld.

⁷³ Rep. Richard Neal, D-Mass recently introduced the "Corporate Patriot Enforcement Act of 2002" to permit taxation of U.S. companies that reincorporate overseas to avoid U.S. tax law. HR 3884, 107th Congress (2d Session), 2002.

⁷⁴See e.g. George Carlson and Harvey Galper, "Water's Edge Versus Worldwide Unitary Combination" in Charles E. McLure, ed, *The State Corporate Income Tax: Issues in Worldwide Unitary Combination* (Stanford: Hoover Institute Press) 1984, pp. 1-40.

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there is evidence of tax base erosion within Georgia and this may be due to avoidance based on separate income accounting. Second, only those businesses presently taking advantage of separate income accounting rules would be hurt by a move to combined income reporting.

The advantages of mandating combined income reporting for unitary businesses are many. Fundamentally, combined income reporting eliminates artificial discrepancies in the tax base through accounting and arbitrary allocations of revenues and expenses across state boundaries. Combined income reporting is not a panacea either. Mandating it will require a very clear set of regulations in complex areas.

However, combined income reporting still is controversial as an apportionment method. Critics have argued that combined income reporting is contrary to the formulary apportionment of a single taxpayer's income. The reality is that single taxpayer formulary apportionment has become a fiction in a world where unitary businesses have at their disposal a variety of avenues to artificially reduce their state tax liabilities.

Combined reporting should be distinguished from consolidated return filing. The following paragraphs describe some of these distinctions and briefly review the scope of issues that will have to be decided if mandatory combined income reporting were adopted. Combined reporting is an approach for determining the income attributable to a state from each of the corporations of an affiliated group of companies conducting a unitary business in several states.⁷⁵ When there is more than one corporation in the affiliated group doing business in the state, the unitary income apportioned to the state is, in turn, apportioned among the different companies with nexus in the state.⁷⁶ Depending on the type of combined reporting, not all affiliated corporations in a group may be combined. Combination applies to a "unitary business" and the determination of what this is can vary.

⁷⁵See for example, James F. Buresh and Marc S. Weinstein, "Combined Reporting: The Approach and Its Problems," *Journal of State Taxation*, vol. 1, no.1 Spring 1982, pp. 5-15.

⁷⁶Often the second stage apportionment is not done with the entire income apportioned to the state assessed to the "key corporation" of the group in the state.

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It is important to distinguish between the filing of “combined income reports” and the filing of “consolidated returns.” These two terms are at times used interchangeably, but they are quite different. The objective of combined income reporting is not to tax the income of the affiliated group as a whole or file a consolidated return. Rather, the objective is to determine the portion of the income from the unitary business attributable to the companies with nexus, i.e. operating, in the state. The combined income report is an informational return rather than a tax return. Each corporation in a combined report with nexus in the state still has to file its own corporate tax return.

By contrast, in a consolidated return the total net income of the corporations in the group is filed in a single return and a single tax is paid (even though each of the corporations is jointly and severally liable for payment). In the case of consolidated returns, net income is not limited to that related to a specific unitary business. Of course, when the consolidated business operates in more than one state, apportionment will be necessary in the consolidated return.

Two important decisions need to be made if the State of Georgia were to require combined income reporting for all unitary business. These concern the “basis”, or how far and wide the combination should go, and the “standards”, or how to determine which corporations should file a combined report.⁷⁷

There are three choices for the basis of combined income reporting, although some combinations of these three are also possible. The first is worldwide combination, which includes all domestic and foreign income. A second choice is to combine with a domestic or water's edge limitation, which would then only include U.S. source income. Finally, Georgia could adopt a nexus combination including only those companies with nexus in the state, or corporations domiciled in the state or some combination.

⁷⁷ Several administrative issues will also need to be addressed involving rules for the consolidation of intercompany transactions, the merging of different accounting periods, how to address partnerships in the affiliated group, how to deal with foreign source income, and whether there should be some modification of the apportionment formula to recognize the different nature of some of the corporations such as financial institutions and insurance companies.

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The standards used to determine when a group of affiliated companies actually constitute a unitary business vary. The most common standard is based on the “three-unities” of common ownership, common management and common operation. Common ownership is typically interpreted to exist when another corporation owns 50 percent or more of the stock of another corporation. Common management is typically interpreted to exist when there are overlapping boards of directors or common managers in key positions. Common operation is interpreted to exist when there are common management functions, financing, accounting, advertising, or purchasing.

Other standards rely on the existence of dependency or contributions between affiliated corporations, similarities in the line of business, or significant inter-corporate transactions.

4. *Alternative Minimum Tax*

Another method of potentially reducing the loss of corporate income tax receipts is the Alternative Minimum Tax (AMT). Many states at present have an AMT together with the regular corporate profit tax. The AMT used by the states vary from direct application of the federal AMT to a flat amount, such as \$250. Georgia does not have an AMT, although the franchise tax levied on net worth may be interpreted as such.⁷⁸

There is a strong justification for an AMT. First, it is possible that corporations do not pay an income tax because of net operating losses, use of tax shelters, or the use of separate accounting. If the corporate tax is viewed as a tax on business to support services the state provides, then all companies should contribute even if a company has zero or negative income. Thus, an AMT can be justified as a fee to the state for services provided the company.

Another, less justifiable reason for the AMT is based on the assumption that corporations and not shareholders, employees, and consumers pay the corporate tax. Thus, corporations are separate entities and must contribute to the state revenue

⁷⁸Note, the occupation tax and local franchise tax levied on banks and other depository financial institutions and creditable against the corporate income tax may be considered as a minimum tax since banks have to pay the tax even when they do not have profits.

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merely because of their existence. To an economist, however, corporations do not pay taxes. It is the shareholders, employees, and consumers who pay the tax as the corporation is merely an artificial entity set up to do business with limited liability.

The AMT also suffers from the fact that it is an add-on (or a band-aid) tax used when the corporate tax structure is being used in ways it might not have been intended to be used. An AMT is easy to put in place. However, an AMT does not necessarily solve the long-run problem declining tax receipts, since it does not address the fundamental underlying structural problems in the tax code.

5 *The Value-Added Tax*

No discussion of state taxes would be complete with out a general discussion of the Value-Added Tax (VAT). In fact, while its use in the U.S. has been limited to Michigan and New Hampshire, it is in use in over 100 countries worldwide. Further, while never enacted at the Federal level, it has been discussed for over 20 years as a replacement or supplemental tax.⁷⁹

The VAT is a tax applied to all commercial activities involving the production and distribution of goods or the provision of services. At one level it appears to be a sales tax, that is, it appears as a tax on a transaction. However, what makes it theoretically different is that it is actually a tax on the value-added in the production and distribution of goods or services. For example, a company purchases raw materials for \$100, fabricates them and sells the resulting product for \$150. The value added would be the difference between the cost of materials and the revenue received from this sale. Thus, the tax would be placed on the \$50 value added. If the fabricated materials were then turned into manufactured goods and resold for \$200, the value-added would be the additional \$50. Thus, the value-added tax would be placed upon the transaction at each stage of production. In contrast, the retail sales tax would be placed on the final transaction.

The major differences between the retail sales tax and the value added tax involve the administration of the two taxes. A simple example gives the flavor for

⁷⁹ See, e.g., Henry Aaron, "Introduction and Summary," in *The Value-Added Tax: Lessons from Europe*, H. Aaron ed. (Brookings Institution: Washington, DC) 1981.

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the potential administrative differences. Since the retail sales tax is on the final transaction, the audit process would focus on retail establishments and their collection and reporting of the tax. In contrast, the value-added tax would require an audit process that could audit at all levels of transactions. The administrative burden of the retail tax, while not minimal, is much less than would likely be imposed on all producers and service providers, as well as retailers.

There are two ways of imposing the VAT. Note first that the base of the VAT is sales less cost of materials. This difference equal wages, interest and profits. The first method is called the invoice method. Under this method, a firm is taxed on its total sales, but it is able to claim a credit for any VAT included on any invoice the firm pays. Thus, this method has a built-in enforcement incentive. The second method is similar to how the corporate income tax is currently handled, except that the firm includes wages, interest, and profits on the return, not just profits.

The major benefits espoused by promoters of the VAT are increased revenues, increased savings formation, and increased investment. For example, if a VAT were in place, it could conceivably cover the production of both goods and services. While we tax corporate income for goods and service providers, the sales and use tax generally does not cover the sales of services. Thus, broadening the tax by using a VAT base beyond the sale of goods could conceivably bring in significant revenue to the state.

Another benefit of the VAT is that it is a consumption tax. That is, the base of the tax is ultimately consumption, not profits. Thus, savings in the form of a company's retained earnings or personal savings are not taxable. Since savings are tax-free, there is a corresponding incentive to save or invest. A firm also has an incentive to invest in physical capital, as accounting depreciation has no influence on investment decisions in the absence of an income tax. Finally, in the absence of an income tax, there is no double taxation of corporate income and the subsequent taxation of the corresponding dividends with the personal income tax.

One of the major problems with the VAT is that it can mask the cost of government. If the tax is built into the price of a good or service one may forget that

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one is paying taxes. Further, the VAT may be regressive. In fact, the issue may be worse as the VAT is applied to every sale. In Georgia, we currently exempt most food for home consumption from the sales and use tax based on the assumption that lower income consumers consume more food as a percentage of income than higher income consumers. An all-inclusive VAT would cover food. Another problem, alluded to above, is that the administrative burden is likely higher than the retail sales tax burden for both the state and the taxpayers.

As mentioned above, Michigan and New Hampshire currently have a value-added tax. Michigan's Single Business Tax was put in place in 1976, but starting in 1999 the tax is being phased out over a 23-year period because of its complexity and perceived unfairness.⁸⁰ New Hampshire's tax is simpler and has a much lower rate than the Michigan tax (2.3 percent versus 0.75 percent). Essentially, New Hampshire's tax is a tax on wages, compensation, and dividends and is taxed at a rate of 0.75 percent. The only exemptions are for companies with gross receipts less than \$150,000 or the sum of wages, compensation, and dividends is less than \$75,000.⁸¹ The Michigan tax differs from the New Hampshire tax due to numerous exemptions, deductions, and credits. However, capital investment is specifically deductible in Michigan.

Kenyon undertook an analysis of the New Hampshire VAT.⁸² Her analysis is limited to New Hampshire, but may provide some insight to the issues in Georgia. New Hampshire does not have a retail sales tax and its income tax is narrowly limited to taxing dividends and interest income. Thus, the New Hampshire VAT tax did not replace any current tax. A broader income tax is prohibited for political reasons, yet the state needed to complement its tax revenues in some meaningful manner. In fact,

⁸⁰There are a number of exemptions, deductions, and credits to the tax that increased its complexity. Further, since the tax is payable when corporate income is zero or negative many thought the tax to be unfair. For a discussion of the two state implementations of the VAT, see Daphne Kenyon, "A New State VAT? Lessons from New Hampshire," *National Tax Journal* 49 (September 1996): 381-399.

⁸¹NH Revised Statutes Annotated 77-E.

⁸² See Kenyon *supra* note 80.

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the VAT was successful, accounting for approximately 20 percent of state revenue in 2001.⁸³

The use of a VAT in Georgia would likely be part of a significant tax reform as its imposition could likely affect the sales and use tax. Unlike New Hampshire, Georgia has significant revenue from the sale and use tax as well as the corporate income tax. Thus, the revenue demand from the VAT as a replacement for these taxes would likely be significant. However, Georgia could employ the VAT as a new complementary tax rather than a replacement of the corporate income and sales and use tax. In this case, the benefits to Georgia might be akin to the imposition of an alternative minimum tax. The VAT may be able to reduce the erosion of the corporate income tax, especially if it was applied to all business irrespective of corporate form. Further, the VAT is better in the sense that it may likely raise more revenue than the AMT, and is, on the surface, less arbitrary than the AMT.

⁸³ New Hampshire Department of Revenue Administration, *Annual Report, 2001*, <http://webster.state.nh.us/revenue/publications/index.htm>.

Summary and Conclusions

The Georgia corporate income tax is the third largest contributor to state revenues behind the personal income tax and the state sales tax. However, it is an unstable source of state revenue for two reasons. First, the tax base, i.e. profits, fluctuates widely over the business cycle. Second, it is “leaky” in the sense that the tax is becoming a smaller portion of the state’s tax revenues. This loss of revenue is likely due to a combination of factors such as the increased use of tax credits; the use of sophisticated tax planning at the federal and state level which can allow for strategic tax reporting in separate tax returns or the use of special holding company structures; the use of different organizational forms to avoid the corporate income tax; and changes in the apportionment formula. Further, the net worth tax, while never a large contributor to the state’s tax receipts, has become even less important over time.

This report also considered five potential changes to the Georgia corporate income tax. The first is the need to reexamine the nexus requirements in light of changing technology. Policy makers may need to address issues of whether expansion or reduction of nexus is desirable. Second, the issue of the apportionment formula is likely to be revisited. Evidence shows that there will be winners and losers from a change to a single factor apportionment formula, but any benefits are likely to be found only in the long-term. Third, separate accounting has problems. Taxpayers can employ sophisticated tax strategies to shift income overseas or to other states. This will only get worse without changes to how corporations report their company-wide income. However, it should be noted that states might compete on how they allow firms to report just as they do with other parts of the tax code so as to attract business to the state. Fourth, an AMT could be employed to reduce the “deterioration” of corporate revenues to the state. The AMT does not really solve any problems, but it may prolong the time before they have to be dealt with properly.

Finally, we discuss the value-added tax. The imposition of a VAT in Georgia needs a careful consideration. If a full reform of Georgia’s tax system is undertaken, an examination of the VAT is warranted. The VAT has a number of benefits.

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However, it does come with some increased administrative costs. Alternatively, if there is no major reform of the overall Georgia tax system, the VAT may be employed as a complementary tax rather than a replacement tax. This may be useful to offset the erosion we observe in the corporate income tax.

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