



# FISCAL RESEARCH CENTER

## **Georgia's Corporate Income Tax: A Description and Reform Options**

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**ANDREW YOUNG SCHOOL**  
OF POLICY STUDIES

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# Georgia's Corporate Income Tax: A Description and Reform Options

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# Georgia's Corporate Income Tax: A Description and Reform Options

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## I. Introduction

Georgia imposes two separate taxes on corporations, the corporate income tax and the net worth tax. Together, these two taxes generated \$670.4 million in revenue in FY 2011, accounting for 4.3 percent of Georgia's total state tax revenue.<sup>1</sup> The revenue generated pales in comparison to the revenue generated by the personal income tax and the sales tax. Furthermore, the corporate income tax is a small share of total state and local taxes on business. Cline, Neubig and Phillips (2009) estimate that in Georgia in 2008 the corporate income tax accounted for only 6.6 percent of state and local taxes on business, while property and sales taxes accounted for 69.8 percent. Nevertheless, the corporate tax revenue is not an inconsequential sum.

In 2002, the Fiscal Research Center published a report that provided an overview of Georgia's corporation income tax (Grace 2002). Over the past 14 years, the Fiscal Research Center has published several studies that discuss various aspects of Georgia's corporation income tax or potential alternatives to that tax.<sup>2</sup> This report updates Grace's overview of Georgia's corporate income tax and the net worth tax, explaining how the taxes are calculated and how the corporate income tax compares to corporate income taxes levied by other states. In addition, the report explores five potential options for change: reducing the corporation income tax rate, eliminating or modifying the net worth tax, requiring combined reporting, adding a throwback requirement to the apportionment formula, and conforming to certain federal corporate income tax provisions.<sup>3</sup>

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<sup>1</sup> The corporate income tax is not applicable to insurance companies or financial institutions. Georgia imposes a tax on premiums written; see Grace (2010) for a discussion of Georgia's insurance premium tax. The revenue from this tax and other charges on insurance companies was \$274.4 million in FY 2010. Georgia levies a financial institutions business license tax on depository institutions, which is a 0.25 percent tax levied on gross receipts. The revenue from this tax amounted to \$14.6 million in FY 2010. These taxes are not considered in this report.

<sup>2</sup> These publications include Bird (2007), Edmiston (2001; 2003), Edmiston and Arze (2002), Grace (1998, 2004), Rider (2011), Wheeler (2009a; 2009b; 2005), Wheeler and Monkam (2007), Rork and Wheeler (2008), and Wheeler and Sennoga (2007).

<sup>3</sup> Fox, Luna, and Murray (2005) provide an economic analysis of the state corporation income tax and various provisions such as the apportionment formula, combined reporting, and throwback sales.

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### **II. The Basics of the Georgia Corporate Income Tax**

This section outlines the six basic steps involved in calculating the Georgia corporate income tax (CIT) liability.

1. The calculation of the Georgia CIT liability begins with the firm's federal taxable income from the federal corporate income tax return (namely, line 30 on Form 1120).
2. Several additions and subtractions are made to federal taxable income in order to obtain Georgia taxable income. These additions and subtractions are listed in Table 1. Some adjustments result from changes in the Internal Revenue Code (IRC) that Georgia has not adopted. Each year the federal government makes changes to the IRC. And, each year the Georgia General Assembly adopts legislation conforming Georgia income tax to the new IRC. However, there are changes to the IRC that Georgia decides not to adopt. Thus, adjustments to federal taxable income have to be made to account for the changes the federal government made to the IRC that Georgia did not adopt. For example, at various times the federal government adopted depreciation schedules that allowed a much faster depreciation of assets than was previously allowed. Georgia, like many other states, did not adopt all of those changes. For example, Georgia does not allow for bonus depreciation, and the deduction associated with Section 179 expensing of capital investments has at times been more limited than is allowed at the federal level. Thus, firms have to make an adjustment to taxable income to account for the different depreciation schedules used for federal versus Georgia corporate income taxes. (Depreciation, including Section 179 expensing and bonus depreciation, is discussed in some detail below.)

Other adjustments date back to the time Georgia adopted its corporate income tax and are either based on Constitutional issues or on the basic concept of Georgia taxable income. These adjustments reflect sources of income that Georgia taxes but the federal government does not, and vice versa, and deductions that the federal government allows but Georgia does not. For example, the federal government taxes the interest on U.S. obligations but Georgia cannot. On the other hand, the federal government exempts the interest earned from state and local municipal bonds of any state, while Georgia only exempts the interest earned from Georgia municipal bonds.

3. Many corporations operate in multiple states. However, federal law and court rulings prevent states from imposing their corporate tax on all of the income of such multi-state firms. First of all, a state cannot impose a tax on a corporation unless that firm has nexus in the state, which generally

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**TABLE 1. ADJUSTMENTS TO FEDERAL TAXABLE INCOME**

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The following must be added to federal taxable income since Georgia does not conform to these federal provisions:

- Payments of more than \$600 made to employees who are not legally allowed to work in the U.S.
- Deduction for income attributable to domestic production activity, that is, IRC Section 199 provision. (See below for a discussion of Section 199.)
- All intangible expense and related interest expense directly or indirectly paid to a related member. (See below for a discussion of passive investment companies.)
- All captive REIT (Real Estate Investment Trust) expenses directly or indirectly paid to related members. (See below for a discussion of tax planning.)
- Non-Georgia state and municipal bond interest.
- Federal net operating loss other than that attributed to operations in Georgia.
- Net income or net profit taxes imposed by a taxing jurisdiction other than Georgia.
- Expenses attributable to tax exempt income.
- Depreciation on child care property if the corporation claims a credit for qualified child care property.

The following are subtracted from federal taxable income:

- Interest on certain Georgia municipal bonds that were taxed by the federal government.
- Interest on obligations of the United States (must be reduced by direct and indirect interest expense).
- Exception to intangible expenses and related interest cost.
- Exception to captive REIT expenses and costs.
- 10 percent of qualified payments to minority subcontractors, up to a maximum subtraction of \$100,000. Pertains to payments for work on state contracts.

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NOTE: This list applies to adjustments made to the 2011 corporate tax return.

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means that a firm has to have physical presence in the state. Second, a procedure is required to determine the amount of the income from a multi-state firm that a state can tax. The procedures that are used involve distinguishing between non-operating income that is allocated to a state and operating income that is apportioned to a state.

Non-operating revenues, such as investment income from intangibles, investment interest on bond holdings, rental income on investments, gains from sale of tangible property not held, owned, or used in the trade or business, are assumed to be earned at the corporation's headquarters. One hundred percent of this type of revenue is allocated to the state in which the firm is domiciled and is taxed by that state. The share of the firm's other income that is subject to state tax is determined by multiplying that income by an apportionment ratio, the value of which is specific to that firm. For multi-state firms operating in Georgia the apportionment ratio equals the firm's sales (gross receipts) in Georgia as a percentage of the firm's total sales (gross receipts) in the U.S. The ratio is used to determine the share of the firm's operating income that is taxed by that state. Other states use different procedures to determine the apportionment ratio. The apportionment ratio is discussed in more detail in Box 1.

4. The firm is allowed to subtract net operating loss carry forwards in order to arrive at Georgia taxable income. The total taxes that two firms pay should be the same if two firms have the same total profits over a number of years, even if one firm has losses some years and profits in other years. Thus, the state allows firms to carry forward net operating losses and deduct them in the years in which the firm has positive net income.
5. Georgia has a flat CIT rate of 6 percent. To determine gross CIT liability, the firm's Georgia net taxable income is multiplied by 6 percent.
6. Finally, any tax credits the firm is allowed are subtracted from the gross CBT liability to arrive at net tax liability. Georgia has 30 different tax credit programs that corporations may earn. Table 2 lists these different credit programs; for a description of each of the income tax credit programs see Wheeler (2011).



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### BOX 1

#### Apportionment of Profits of Multi-State Firms

Rather than requiring firms that operate in multiple states to maintain separate financial records for their operations in each state, as is done for multi-national firms, states require firms to calculate an apportionment ratio using the state's apportionment formula. This apportionment ratio is used to determine the amount of the firm's operating income that is taxed in a particular state. States use three factors, either alone or in combination, in the apportionment formula, namely, sales (gross receipts), payroll, and property. In all cases, a firm calculates the ratio of, say, sales in the state to its sales throughout the entire United States.

Most states use what is known as the three-factor formula. In this formula, the ratios for sales, payroll, and property are added and divided by 3. Several states have, over the past several years, adopted alternative formulas, generally increasing the importance of sales in determining the apportionment ratio. Several states now double weight the sales factor, that is, the sales factor is counted twice, and thus, the total of two times the share of sales plus the share of the other two factors is then divided by 4. Georgia, and nine other states have adopted an apportionment formula that uses only the sales factor. Imposing an apportionment formula based only on the sales factor is seen by many as having a positive effect on economic development within a state. Under the traditional three-factor apportionment formula, firms that increase their physical property or employment within a state face a higher apportionment rate which may lead to an increased tax liability. Applying only the sales factor in the formula means that increases in employment or physical investment do not result in increases in the firm's tax liability.

For some industries a different method is used to apportion taxable income. For corporations whose income comes mainly from transporting passengers and cargo by air, the apportionment is based on the Georgia share of the firm's air miles, tons of cargo handled, and originating miles, with the weights on the first two factors being 0.25 and the weight on the third factor being 0.5. Special provisions are also made for apportioning profits of credit cards firms, public service corporations, pipeline firms, and railroads.

Georgia's current apportionment formula was fully adopted in 2008. Given its newness, we do not discuss the possibility of changing the formula. For an analysis of the change in Georgia's apportionment formula see Edmiston (2001), Edmiston and Arze (2002), and Wheeler (2009a).

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**TABLE 2. BUSINESS TAX CREDITS**

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*Employment & Investment*

1. Employer's Jobs Tax Credit
2. Quality Jobs Tax Credit
3. New Facilities Jobs Credit
4. New Manufacturing Facilities Property Credit
5. Manufacturer's Investment Tax Credit
6. Optional Investment Tax Credit
7. Investor's Credit

*Supplemental Credits*

8. Port Activity Tax Credit
9. Alternate Port Activity Tax Credit

*Economic Development*

10. Film Tax Credit
11. Research Tax Credit
12. Seed-Capital Fund Credit
13. Tax credit for existing business enterprises undergoing qualified business expansion.

*Employee Benefit*

14. Qualified Health Insurance Expense Credit
15. Teleworking Credit
16. Qualified Transportation Credit
17. Business Enterprise Vehicle Credit
18. Employer's Credit for Purchasing Child Care Property / Employer's Credit for Providing or Sponsoring Child Care for Employees

*Housing*

19. Low Income Housing Credit
20. Historic Rehabilitation Credit

*Environmental*

21. Diesel Particulate Emission Reduction Technology Equipment
22. Low and Zero Emission Vehicle Credit / Electric Vehicle Charger Credit
23. Land Conservation Credit
24. Clean Energy Property & Wood Residuals Credit

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*Table 2 continues next page...*

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**TABLE 2 (CONTINUED)**

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*Environmental* (continued)

- 25. Energy or Water Efficient Equipment Credit
- 26. Tax credit for ground water-usage
- 27. Tax credit for water conservation facilities and qualified water conservation investment property

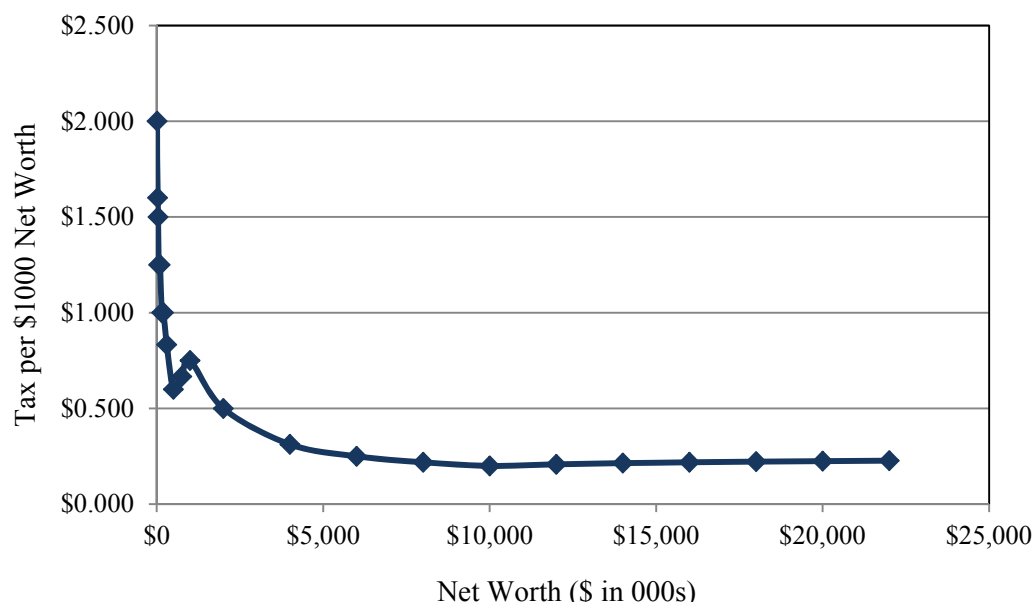
*Education*

- 28. Employer's Credit for Basic Skills Education
  - 29. Employer's Credit for Approved Employee Retraining
  - 30. Qualified Education Expense Credit
-

### III. Georgia's Net Worth Tax

The net worth tax is based, as its name implies, on the net worth of the firm, that is, the difference between the firm's assets and liabilities. The tax is imposed on all corporations other than those organized as a non-profit, an insurance firm, or a financial institution. As with the corporate income tax, a multi-state firm uses the apportionment ratio to determine the net worth that is subject to Georgia's net worth tax. However, the factors used to apportion a firm's net worth are not the same as for corporate income. For the net worth tax, the apportionment ratio equals the share of a firm's assets and gross receipts in Georgia to the firm's total assets and gross receipts. Net worth is presumed to be the net worth that is disclosed on the corporation's books, and includes, but is not limited to, issued capital stock, paid-in surplus, and earned surplus.

**FIGURE 1. EFFECTIVE NET WORTH TAX RATE**



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The net worth tax liability is \$10 if net worth is \$10,000 or less (including zero) and increases to a maximum of \$5,000 if net worth is \$22 million or more. Table 3 shows the tax schedule and the effective tax per \$1,000 of net worth for the net worth at the bottom of each bracket. Figure 1 shows the tax per \$1,000 of net worth. Note that the effective tax rate generally falls as net worth increases, so that the tax paid per dollar of assets falls as the value of firm assets increase.

**TABLE 3. NET WORTH TAX RATES**

Net Worth (in thousands)		Tax	Tax per \$1,000 of Minimum Net Worth in Category
--	Not exceeding \$10	\$10	NA
Over \$10	Not exceeding \$25	20	2.000
Over 25	Not exceeding 40	40	1.600
Over 40	Not exceeding 60	60	1.500
Over 60	Not exceeding 80	75	1.250
Over 80	Not exceeding 100	100	1.250
Over 100	Not exceeding 150	125	1.250
Over 150	Not exceeding 200	150	1.000
Over 200	Not exceeding 300	200	1.000
Over 300	Not exceeding 500	250	0.833
Over 500	Not exceeding 750	300	0.600
Over 750	Not exceeding 1,000	500	0.667
Over 1,000	Not exceeding 2,000	750	0.750
Over 2,000	Not exceeding 4,000	1,000	0.500
Over 4,000	Not exceeding 6,000	1,250	0.313
Over 6,000	Not exceeding 8,000	1,500	0.250
Over 8,000	Not exceeding 10,000	1,750	0.219
Over 10,000	Not exceeding 12,000	2,000	0.200
Over 12,000	Not exceeding 14,000	2,500	0.208
Over 14,000	Not exceeding 16,000	3,000	0.214
Over 16,000	Not exceeding 18,000	3,500	0.219
Over 18,000	Not exceeding 20,000	4,000	0.222
Over 20,000	Not exceeding 22,000	4,500	0.225
Over 22,000	--	5,000	0.227

#### **IV. Trends in Revenue and Comparisons Across States**

The corporate income tax was first levied in Georgia in 1929, at the same time as the personal income tax. The net worth tax was first imposed in 1931. The corporate income tax rate has varied over time. When the corporate income tax was adopted the rate was one-third of the federal tax rate, but was set at 4 percent in 1931. The current tax rate of 6 percent was adopted in 1969, when the rate was increased from 5 percent. The net worth tax schedule is the same as when the tax was first imposed (see Table 3).

There are several measures of the relative importance of corporations in the U.S. Data from *County Business Patterns* suggest that in 2009 C-corporations comprised 34 percent of all for-profit establishments, employed 54 percent of all employed workers, and paid 61 percent of the total payroll.<sup>4</sup> Using data from the IRS Statistics of Income, C-corporations accounted for 62 percent of all business receipts in 2008. We are unable to estimate the relative importance of corporations in Georgia.

##### **A. Trends in Corporate Income and Net Worth Taxes**

Figure 2 shows the change in Georgia corporate income tax revenue, adjusted for inflation, over the period FY 1980 through FY 2010. While the revenue in FY 2010 is slightly less than the revenue in FY 1980, there is a general upward trend in real corporate income tax revenue over the period. What is unmistakable from Figure 2 is the cyclical nature of the CIT, with wide fluctuations between periods of economic growth and recession.

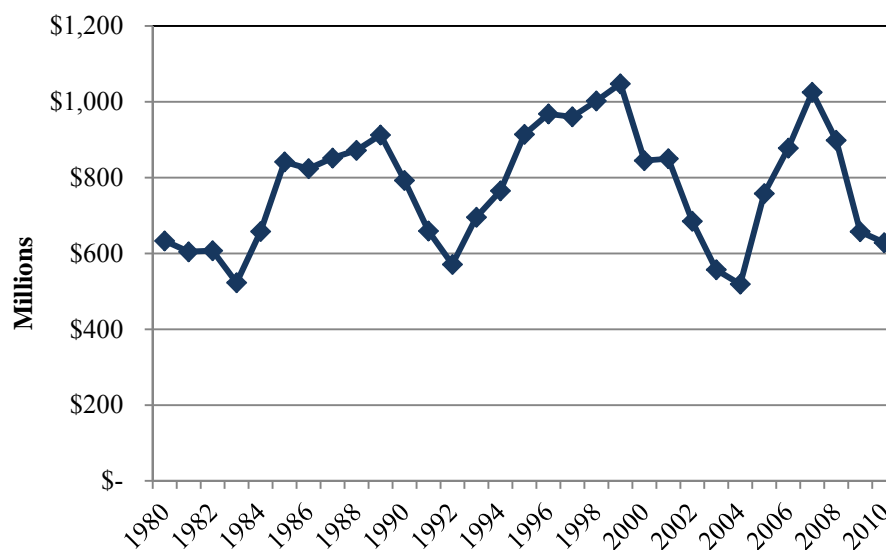
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<sup>4</sup> Computed by authors using data from U.S. Statistics of Business, which is compiled from 2009 County Business Patterns.

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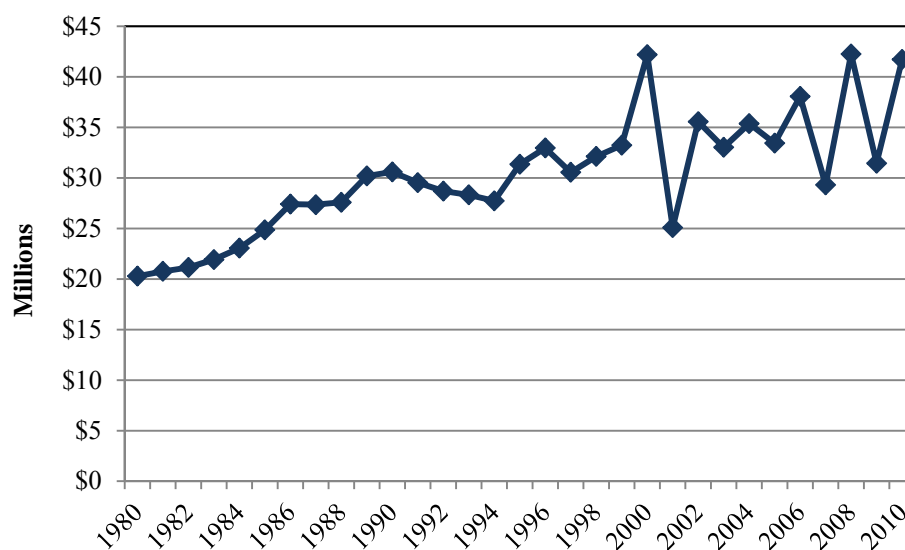
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**FIGURE 2. CORPORATE INCOME REVENUE, INFLATION ADJUSTED**



SOURCE: Author's calculations based on data from the Georgia Department of Revenue.

**FIGURE 3. NET WORTH TAX REVENUE, INFLATION ADJUSTED**



SOURCE: Author's calculations based on data from the Georgia Department of Revenue.

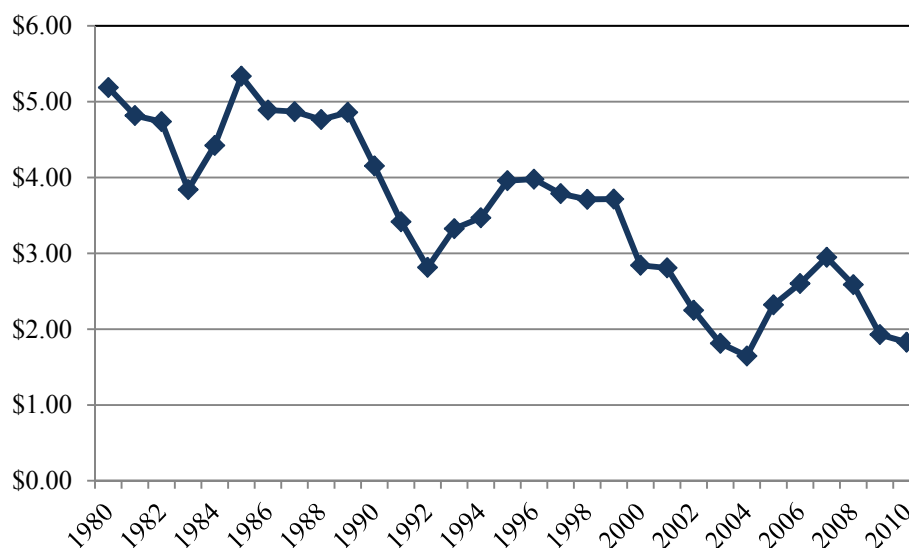
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Figure 3 is the equivalent to Figure 2, but for the net worth tax. Until FY 2000 net worth tax revenue gradually increased, with small fluctuations. The period since FY 2000 reflects what appears to be increased cyclical behavior. Because there is no evidence that net worth has become more cyclical, we suspect that this pattern has more to do with changes in how the Department of Revenue reports net worth tax revenue than actual fluctuations in revenue.<sup>5</sup>

Figure 4 plots corporate tax revenue per \$1,000 of personal income. Personal income is a measure of the size of the Georgia economy (using gross domestic product rather than personal income paints a very similar picture.) Figure 4 shows that relative to the size of Georgia's economy, corporate income tax revenue has declined, and declined significantly. In FY 1980, corporate income tax revenue was \$5.19 per \$1,000 of personal income, while by FY 2010 it had fallen to \$1.83, a decrease of 64.7 percent.

**FIGURE 4. CORPORATE INCOME TAX REVENUE PER \$1,000 OF PERSONAL INCOME**



SOURCE: Author's calculations based on data from the Georgia Department of Revenue and U.S. Bureau of Economic Analysis.

<sup>5</sup> The Georgia Department of Revenue has recently implemented a new system for tracking receipts. It is possible that the increase in volatility is largely reflective of the transition between the old and new system.



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The cyclical nature of the Georgia corporate income tax and the general decline relative to the size of the economy has been explored by Wheeler (2009b). Furthermore, these patterns are not unique to Georgia (Fox and Luna [2002]; Cornia, Edmiston, Sjoquist, and Wallace [2005]).

Several explanations for the relative decline nationally in state corporate income tax revenue have been suggested, including, more aggressive tax planning, reduced tax rates, increased tax credits, and the shift in organization form. Regarding the latter, the federal tax code distinguishes between two types of corporations, C-corporations and S-corporations. C-corporations are what one usually considers corporations, that is, a business owned by a large number of stock owners and for which profits are typically not entirely distributed to owners. S-corporations are generally smaller, and cannot have more than 100 stock holders or be owned by another C-corporation. S-corporations and limited liability corporations (LLC) are “pass through” entities, meaning that earnings are not taxed under the corporation income tax, but all profits are passed through to the owners and taxed under the personal income tax.

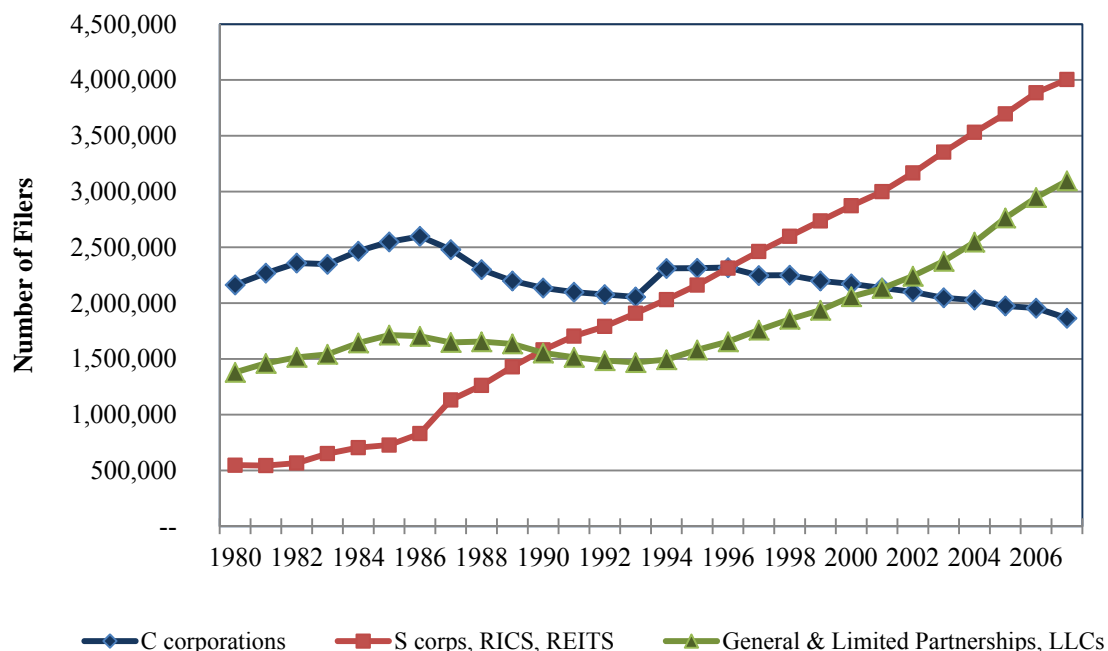
Corporations can elect to be treated as an S-corporation. S-corporations can retain earnings in the firm, but these retained earnings are included as income of the stock owners when they file their personal income tax returns. Georgia allows subchapter S elections only if all stockholders are subject to personal income tax in Georgia, including nonresidents.

In addition to S-corporations, there are small C-corporations that arrange their finances so that their corporate tax liability is zero. For example, they pay bonuses and make purchases at the end of the tax year in order to have zero taxable profit.

Because of the tax advantage of operating as an S-corporation, over the past 25 years many smaller corporations have converted to S-corporation status. Figure 5 shows the change in the composition of organization form for the U.S. Note that the number of C-corporations has declined since the mid-1980s, while the other business forms have increased. There is limited data for Georgia on this topic, but what is available suggests a pattern similar to that seen in Figure 5. In Georgia, in 2008 there

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**FIGURE 5. NUMBER OF U.S. BUSINESS ENTITIES, 1980–2007**



Source: Statistics of Income, IRS.

were 173,000 S-corporations and 82,000 C-corporations.<sup>6</sup> Ninety percent of corporate income tax returns reported zero or negative corporate taxable income. While some of those returns are large C-corporations with losses, most are S-corporations or small C-corporations that manage their finances so as to have no taxable income.

The decrease in C-corporations nationally is reflected in the decline of C-corporations' share of total U.S. business receipts from 69 percent in 1998 to 62 percent in 2008.<sup>7</sup> Furthermore, the number of C-corporate tax returns filed in 2008 was 21 percent lower than that filed in 1998, while the number of total business returns increased by 31 percent between 1998 and 2008.

<sup>6</sup> Based on Georgia corporate returns for 2008, as computed by the authors.

<sup>7</sup> Internal Revenue Service, Statistics of Income, as computed by authors.

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### B. Inter-State Comparison of Corporate Income Taxes

There are 44 states that have a corporate income tax. Four states do not tax corporations (Nevada, South Dakota, Washington, and Wyoming) and two states (Ohio and Texas) tax corporations other than with a corporate income tax.<sup>8</sup>

Table 4 shows the distribution of state corporate tax revenue for FY 2009 as a share of the state's total taxes, using data from the U.S. Census Bureau. For Georgia, the share is 4.32 percent. Table 5 shows the distribution of corporate tax revenue for FY 2009, as reported by the Bureau of the Census, per \$1,000 of state personal income.

**TABLE 4. STATE CORPORATE TAX REVENUE  
AS A SHARE OF TOTAL TAX REVENUE**

<b>CIT/Taxes, 2009</b>	<b>Number of State</b>
0% to 2.9%	7
3.0% to 3.9%	10
4.0% to 4.9%	14
5.0% to 5.9%	7
6.0% to 6.9%	3
7.0% and over	9

Source: Bureau of the Census.

**TABLE 5. STATE CORPORATE TAX REVENUE  
PER \$1000 OF STATE PERSONAL INCOME**

FY2009	
CIT/(\$1,000 of GDP, or state personal income)	
0 to 1.99	16
2.00 to 2.99	3
3.00 to 3.99	21
4.00 to 4.99	5
5.00 <	5

SOURCE: Authors' calculation based on data from Bureau of the Census and Bureau of Economic Analysis.

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<sup>8</sup> Texas has what it calls a margin tax. The margin tax allows firms to choose one of three tax bases, each of which attempts to reflect income, by which to determine their tax liability. But the tax is not limited to business entities that are organized as corporations. For this reason and because none of the three choices result in a standard corporate income tax base computation, the margin tax is not considered a traditional corporate income tax. Ohio levies a commercial activities tax on all business entities operating in the state, the base of which is gross receipts instead of corporate income.

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Of the states with a corporate income tax, 33 states, including Georgia, have a flat corporate tax rate. The other 11 states have a progressive rate structure, although for all but one state the maximum tax rate is reached at less than \$250,000 in net taxable income. Maximum tax rates range from 4.0 percent in Kansas to 12.0 percent in Iowa. There are seven states with a maximum tax rate that is less than Georgia's 6 percent rate. Table 6 summarizes recent charges to the corporate income tax by other states. Table 7 provides a comparison of the main features of the state corporate income tax beyond Georgia and its border states.

**TABLE 6. CHANGES IN CORPORATE TAX STRUCTURES, 2005-2008**

<b>State</b>	<b>Summary of Change</b>
Illinois	Raised rate from 4.8% to 9.5%
Maryland	Raised rate from 7.0% to 8.25%
New Jersey	Eliminated lower tax brackets
Oregon	Added 7% bracket to existing 6% rate
Kentucky	Reduced top rate from 7% to 6%
Massachusetts	Reduced rate from 9.5% to 8.25%
New York	Reduced rate from 7.5% to 7.1%
North Dakota	Reduced range of rates from 2.6-7.0% to 2.1-6.4%
Vermont	Broadened range of rates from 7.0-7.5% to 6.0-8.5%
West Virginia	Reduced its rate from 9.0% to 8.5%
Michigan, Ohio, Texas	Completely revised the manner in which businesses are taxed.

**TABLE 7. CORPORATE INCOME TAX PROVISIONS: COMPARISON ACROSS BORDER STATES**

	<b>Tax Rate</b>	<b>CIT Revenue/ Taxes</b>	<b>CIT Revenue/ GDP in \$100,000</b>	<b>Apportionment Formula</b>	<b>Throwback Rule</b>	<b>IRC Conformity</b>	<b>Combined Reporting</b>	<b>Consolidated Reporting</b>
Alabama	6.5%	5.95%	2.96%	3 Factor	Yes	Yes	No	Allowed
Florida	5.5%	5.75%	2.51%	Double Weighted Sales	No	Yes	No	Allowed
Georgia	6.0%	4.32%	1.76%	Sales	No	Yes	No	No
North Carolina	6.9%	4.40%	2.22%	Double Weighted Sales	Yes	Yes, but Taxable Income before deduction of carryover of NOL	Allowed; Required if a federal consolidated return filed and DOR requires it.	Allowed; Required if a federal consolidated return filed and DOR requires it
South Carolina	5.0%	3.07%	1.38%	3 Factor	No	Yes	No	Allowed
Tennessee	6.5%	7.82%	3.35%	Double Weighted Sales	No, except for sales shipped to the U.S. government	Yes, but Taxable Income before deduction of carryover of NOL	No	No

Source: 2011 State Tax Handbook, CCH, 2010.

## **V. Arguments For and Against a Corporate Income Tax**

There are numerous arguments that have been advanced as to why there should be a corporate income tax in general and a state corporate income tax in particular (see Oakland and Testa (1996) for a list of these rationales). Most of these arguments are rejected by economists. For example, one argument is that corporations should be taxed because they are “wealthy.” This argument is based on the premise that corporations bear the burden of corporation tax. Economists point out that it is not the corporation that bears the tax burden, but rather it is the owners, workers, suppliers, or consumers (or some combination of these groups) who bear the tax burden.

There are two arguments that are advanced by economists to justify a state corporate income tax. One argument is based on the benefit principle of taxation, that is, businesses should be taxed because they benefit from publicly provided services and should be taxed based on the cost of providing those services. This argument, of course, applies to all businesses, not just corporations. Equity considerations imply that corporations and non-corporate businesses should be taxed alike, and that the tax should differ according to the differences in benefits that firms receive from the public services. Furthermore, the cost of the public services a firm benefits from is not likely to be related to taxable income; for example, a firm will benefit from public services whether it earns a profit or not. This argument thus implies that businesses, including corporations, should not be tax on the basis of income. However, designing a tax that satisfies the benefit principle is not easy, and perhaps is impossible.

Another argument advanced in support of a state corporate income tax concerns how the income of the corporation will be taxed by the state. The personal income tax is premised on the principle that income earned in a state should be taxed by that state. Similarly, income earned by a corporation (or any business) from its activities in a state should be taxed by that state. If there was no corporate income tax, the only share of the corporation's profits that would be taxed by the state would be the dividends paid to the firm's stockholders who live in the state. But for large corporations only a small fraction of stockholders are likely to live in the state. Thus,

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the state corporate income tax is a way to tax the income earned in the state by corporations with large numbers of stockholders.

## **VI. Incentives of the State Corporate Income Tax**

The corporate income tax provides a disincentive to businesses since taxes reduce the rate of after tax return on investment. There is a substantial body of literature that has attempted to determine the effect of taxes on economic activity by business, not just corporations. The results of the various studies are mixed; several find no effect, while a few find large effects. The current general consensus among economists is that state taxes have a small negative effect on economic activities in the state. Appendix A provides a discussion of the literature, focusing on more recent studies.



## **VII. Tax Planning and Avoidance**

Corporations can engage in tax planning that reduces taxable profits and that shifts reported profits between states, in particular from high tax states to low tax states. There are several ways that multistate corporations can engage in tax planning to reduce their tax burden; Luna (2004) and Mazerov (2007) provide discussions of state tax shelters. The following are among the more common tax planning strategies.

- If the firm is headquartered in a low tax state (or a state that does not tax non-business income), the firm may be able to reclassify business income to nonbusiness income. The former is apportioned to the several states in which the firm does business, while nonbusiness income is allocated to the state in which the firm is domiciled. A firm's headquarter office can also make loans to its subsidiaries that are taxed as separate corporations, with the interest paid to the headquarter office and taxed as nonbusiness income by the low tax state.
- Transfer pricing, that is, what one subsidiary charges another subsidiary, is a common method through which firms can transfer taxable income between states. For example, a corporation can set up a subsidiary which acts as the management company that provides management services to other subsidiaries. If the management company is located in a low tax state, it can charge a very high (transfer) price for those services, thereby increasing the profits of the management firm in the low tax state, while increasing reported expenses and reducing profits in the subsidiary located in the high tax state. In addition, multinational firms can manipulate transfer prices with foreign affiliates, thereby shifting profits out of the state and the country.
- A particularly extreme example of this shifting is for a firm to establish a passive investment company (PIC), sometimes referred to as a Delaware Holding Company, as a wholly owned subsidiary. The parent corporation sells an intangible asset such as a trademark to the PIC, which it then leases back to the parent company. In this way the firm transfers part of its profit to the PIC. By locating the PIC in a state that does not tax the income from intangibles, the firm is able to reduce its overall state corporate income taxes.
- Establishing a Real Estate Investment Trust (REIT) as a separate wholly owned subsidiary located in a low tax state is another tax shelter. In this case the REIT owns the real property and leases it to the parent corporation, with the profit being taxed only in the state in which the REIT is located.

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There are two studies that have explored the extent of corporate income shifting. Mintz and Smart (2004) use data on individual Canadian corporations to estimate the effect of inter-provincial differences in corporate tax rates on income shifting between provinces by multijurisdictional firms. They estimate that a one percentage point reduction in the tax rate in one province increases taxable income in that province by 8.5 percent. Bruce, Deskins and Fox (2007) find that the existence of tax planning opportunities is associated with taxable income shifting, but they do not provide an estimate of the responsiveness. There are also several studies of inter-country taxable income shifting that find significant evidence of income shifting.

One obvious implication of a firm's ability to shift taxable income is that tax rate differentials are not as important to economic development. If a corporation was considering locating in a high tax state, but is able to shift substantial profits to a low tax state, then the deterrent effect of the higher tax rate on investment will be diminished.

## **VIII. Reform Options**

There are a number of possible options for changing or reforming Georgia's state corporate income tax. In this section we consider five alternatives: reducing the corporate tax rate; eliminating the net worth tax; adding a throwback rule; requiring combined reporting; and conforming to certain IRC corporate tax provisions.

Another possible reform option is to eliminate the corporate income tax entirely. We are unaware of any state that has ceased taxing corporations, but in the past few years two states have replaced their corporation income tax with a gross receipts tax that is levied on all businesses. As its name suggests, a gross receipts tax imposes a tax on a firm's revenue from sales. A gross receipts tax differs from a sales tax in the following ways: a gross receipts tax is imposed on the firm and not the consumer; the gross receipts tax is imposed on all sales, whether that occurs in state or out-of-state, or whether it is on final or intermediate sales; the gross receipts tax is not imposed on sales within the state made by out-of-state businesses. There have been suggestions that states impose a value added tax on businesses, including non-corporate firms, as a replacement for the corporation income tax. Since the Fiscal Research Center (FRC) has published several reports on the gross receipt tax and value added taxes, these options are not discussed in this report.<sup>9</sup>

There have also been calls to reform or eliminate business income tax credits. The FRC has published several reports on tax credits. Thomas (2005) discusses the need for greater information in order to evaluate and monitor the use of the tax credits. Sjoquist and Wheeler (2011) discuss how the state should think about the design of income tax credits. Wheeler (2011) reviews costs and characteristics of Georgia's existing credits.

However, there has been very little analysis of the effectiveness of Georgia's income tax credits, making it difficult to develop recommendations. Nonetheless, the Special Council on Tax Reform and Fairness for Georgians (2011) recommended that the tax credits be reformed. The Tax Reform Council heard evidence that the existing credits are complicated to apply for and to monitor; that generally they do

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<sup>9</sup> See Wheeler and Sennoga (2007), Martinez-Vazquez, et al. (2007), Bird (2007), Wheeler and Monkam (2007).

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not have much value to small and new firms; that the rules and regulations, which were adopted to control the cost of the credits, restrict the usefulness of the credits; that many of the credits are not used or used by a very small number of firms; and that some of the credits were designed for specific firms.

The Tax Reform Council recommended that all of the current economic development tax credits be replaced with a discretionary system with two simple incentives—a credit for job creation and a credit for capital investment. Each year the legislature would authorize an annual amount of revenues to be set aside to fund these credits, and the Georgia Department of Economic Development would be charged with allotting these funds. Furthermore, the Council recommended that the use of these incentives be measured and tracked in order to determine if they yield a positive net return for the state. The Council proposed that all other tax credits be eliminated. Given the Tax Reform Council's recommendation and the prior FRC reports, we do not include any further discussion in this report of eliminating or modifying the corporate income tax credits.

### **A. Reduce the Corporate Income Tax Rate**

One reform option is to reduce Georgia's corporate income tax rate from 6 percent to 4 percent. This reform option was proposed by the Special Council on Tax Reform and Fairness for Georgia (2011). The Tax Reform Council tied this rate reduction to its proposal to decrease the top marginal personal income tax rate from 6 percent to 4 percent. However, there is no inherent reason why the state's corporate income tax rate has to be equal to the top marginal personal income tax rate. In fact, for many years these two rates were not equal in Georgia, nor are they equal at the federal level.

#### *Incentive Effects*

We first discuss the effect of reducing the corporate tax rate on economic incentives for the firm. While reducing the Georgia tax rate from 6 percent to 4 percent is a decrease of 2 percentage points, to determine the economic incentive

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effect it is necessary to also consider the federal corporate income tax and the role of the state apportionment formula.

Other than small corporations, C-corporations pay, at the margin, a federal corporate income tax rate of 35 percent. A firm can deduct Georgia's corporate income taxes in calculating its federal income tax liability.<sup>10</sup> Thus, if a firm's Georgia taxable corporate income increased by \$100, at current tax rates the firm would pay an additional \$38.90 in federal and Georgia corporation income taxes.<sup>11</sup> If Georgia reduced its corporate income tax rate to 4 percent, the firm would pay \$37.60 in total corporation income taxes on the additional \$100 income. This amounts to a reduction in the total tax rate of 1.3 percentage points, or a 3.3 percent reduction in federal plus Georgia corporate income taxes.

Given that firms also pay property and sales taxes, the percentage reduction in total taxes will be even smaller. Cline, Neubig, and Phillips (2009) estimate that Georgia's corporate income tax accounts for 6.6 percent of total state and local taxes that Georgia's corporations pay. This implies that a reduction in the corporate income tax rate to 4 percent would reduce a corporation's taxes by an average of about 0.2 percent of their total Georgia tax burden.

Georgia's apportionment formula also plays an important role in determining the incentive effects of the corporate income tax because the impact on a firm's effective tax rate from a reduction in Georgia's corporate income tax rate depends on the firm's apportionment ratio. Consider a multistate firm that invests in Georgia and earns a return of \$100 million before income taxes. The firm apportions that income using the share of its gross receipts that are earned in Georgia. Assume that the distribution of the firm's sales across states does not change as a result of the investment and that the firm's apportionment ratio is 25 percent. Thus, the income tax liability (federal and Georgia) on the \$100 million of income would be \$35.98

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<sup>10</sup> The firm can also deduct the Georgia income tax in calculating its Georgia's corporate income tax liability for the following year. We ignore this. Georgia is the only state that allows a deduction of its own income tax in calculating Georgia tax liability.

<sup>11</sup> This was calculated as the combination of the following two expressions: federal tax =  $(100 - \text{Ga Tax}) \times 35\%$  and  $\text{Ga Tax} = 100 \times 6\%$ .

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million, which is an effective tax rate on the investment of 35.98 percent.<sup>12</sup> If Georgia reduces its corporate income tax rate to 4 percent, the firm would pay \$35.65 million in combined income taxes, which is an effective tax rate on the investment of 35.65 percent. This amounts to a decrease in the effective tax rate on the investment of 0.33 percentage points, which is a reduction of 0.92 percent in its combined Georgia and federal income tax liability. The smaller the apportionment ratio, the smaller will be the reduction in the firm's effective tax rate due to the reduction in Georgia's corporate income tax rate.

The reduction in the firm's effective tax rate provides an incentive for the firm to increase its investment or economic activity in Georgia. But we are also interested in determining whether the reduction in Georgia's corporate income tax rate provides an incentive for a firm to invest in Georgia rather than another state.

For corporations that already have nexus<sup>13</sup> in Georgia, a reduction in the corporate income tax rate may cause no change in the incentive for the firm to locate new investment in Georgia. The fact that Georgia uses an apportionment formula that relies entirely on sales influences the effect of a reduction in the corporate income tax rate on the incentives for investing in Georgia. To see this, consider the following simple example. Consider a firm that has nexus in Georgia and is deciding whether to locate a new plant either in Georgia or some other state, State A, which uses a three-factor apportionment formula. Because the firm's Georgia apportionment ratio is based only on sales rather than payroll or property, we can generally assume that the location of the new plant will not change the firm's Georgia apportionment ratio.

Suppose further that the plant generates taxable income of \$100 million regardless of which state it locates the plant and that the firm would pay \$2 million in taxes to State A if the plant was located in State A, but would pay no taxes to State A if the plant was located in Georgia. Assuming that the firm has nexus in Georgia and has a Georgia apportionment ratio of 50 percent, the firm would pay taxes to Georgia

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<sup>12</sup> The firm's Georgia income tax would be  $\$100,000,000 \times 0.25 \times .06$ . The firm's federal income tax would be  $(\$100,000,000 - \text{GA tax}) \times 0.35$ .

<sup>13</sup> Nexus refers to a level of economic presence in a state. Once a firm is deemed by state law to have nexus in that state, it is obligated to pay state taxes on income earned from activities in that state.

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of \$3 million ( $= \$100 \text{ million} \times 50\% \times 6\%$ ) regardless of whether the plant was located in Georgia or in State A.<sup>14</sup>

If the plant was located in State A, the firm's tax would be \$5 million (\$3 million to Georgia and \$2 million to State A), which is \$2 million less than if they located in State A. Therefore, the firm would be better off locating the plant in Georgia. Now consider what happens if Georgia reduced its corporate tax rate to 4 percent. The firm would pay \$2 million in Georgia income tax ( $= \$100 \text{ million} \times 50\% \times 4\%$ ) but would pay \$4 million in taxes if it located the plant in State A (\$2 million to Georgia and \$2 million to State A). The tax difference is still \$2 million. Thus, the reduction in Georgia's tax rate does not change the size of the incentive (a saving of \$2 million) to locate the plant in Georgia. While the reduction in Georgia's corporate income tax rate provides no additional incentive for this firm to locate the new investment in Georgia, the rate reduction does reduce taxes paid by \$1 million which may lead to new investment, but not necessarily in Georgia.

This result holds for any corporation that currently has nexus in Georgia. However, for firms that do not currently have nexus in Georgia, locating a plant in Georgia would result in the firm paying Georgia income tax only if the plant was located in Georgia (which gives the firm nexus in Georgia) and had sales in Georgia. In this case, the firm would pay \$3 million in taxes if it located in Georgia and \$2 million in taxes if it located in State A, assuming a 6 percent Georgia corporate tax rate. Lowering the tax rate to 4 percent, reduces the tax liability to \$2 million if the firm were to locate in Georgia. So lowering the rate can act as an incentive for firms relocating from other states.

Using corporate income tax returns for 2008, Table 8 shows the distribution of the number and size of C-corporations in Georgia by the value of the apportionment ratio.<sup>15</sup> We measure size by federal taxable income. 64 percent of firms have apportionment ratios greater than 80 percent. However, 46 percent of Georgia taxable income is earned by firms with apportionment ratios of less than 50

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<sup>14</sup> It is important to understand that because the apportionment ratio is based only on sales, the location of a plant in Georgia will not affect its apportionment ratio or its tax liability to the state.

<sup>15</sup> We obtained the individual corporate income tax returns, stripped of firm identification, for 2008 from the Department of Revenue. We use these data to make several calculations.

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**TABLE 8. DISTRIBUTION OF GEORGIA C-CORPORATIONS BY THEIR GEORGIA APPORTIONMENT FACTOR, 2008**

	Percent of Federal Taxable Income	Percent of Corporations
Apportionment Rate=0 percent (100 percent out of state)	11.3 percent	7.9 percent
0<Apportionment Rate≤25 percent	86.1 percent	25.5 percent
25 percent<Apportionment Rate≤50 percent	0.5 percent	1.5 percent
50 percent<Apportionment Rate≤75 percent	0.1 percent	0.9 percent
75 percent<Apportionment Rate<100 percent	0.4 percent	1.3 percent
Apportionment Rate=100 percent (100 percent in state)	1.5 percent	62.9 percent

SOURCE: Authors' calculations using corporate return data from the Georgia Department of Revenue.

**TABLE 9. AVERAGE APPORTIONMENT RATIO OF GEORGIA C-CORPORATIONS BY FEDERAL TAXABLE INCOME, 2008**

	Average Apportionment Ratio
Federal Taxable Income≤\$0	0.73
\$0<Federal Taxable Income≤\$100,000	0.84
\$100,000<Federal Taxable Income≤\$500,000	0.40
\$500,000<Federal Taxable Income≤\$1,000,000	0.22
\$1,000,000<Federal Taxable Income≤\$10,000,000	0.13
\$10,000,000<Federal Taxable Income	0.05

SOURCE: Authors' calculations using corporate return data from the Georgia Department of Revenue.

percent. Table 9 shows the average apportionment ratio by federal taxable income categories. Note that the ratio falls with increasing federal taxable income. The average apportionment ratio across firms is 66 percent, while the average weighted by Georgia taxable income is 49 percent. This suggests that the change in the effective tax rate from reducing the Georgia tax rate from 6 percent to 4 percent would be rather small for a substantial percentage of economic activity in Georgia.

Reducing Georgia's corporate income tax rate would mean an increase in the return on an investment, which would be expected to increase economic activity. While the literature implies that corporations would respond to a change in the tax rate, the estimates of the magnitude of the resulting change in economic activity vary widely.

We are reluctant to use these published estimates to forecast the effect of changing the Georgia corporate income tax rate given that the studies do not use a



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consistent measure of the tax rates and to the uncertainty of the timing of any response by corporation to a tax change. However, Chirinko and Wilson (2010) do present evidence as to the effect on investment in equipment and structures from a reduction in corporate tax rates. Economic theory suggests that a firm will invest to the point that the return on the investment equals the cost of the funds used for the investment. The latter is known as the user cost of capital. Chirinko and Wilson make use of this theory and existing estimates of other parameters to simulate the effect on investment of a change in the corporate income tax rate for each state. For Georgia, they estimate that a one percentage point reduction in the corporate income tax rate would increase investment in structures and equipment by 0.86 percent in the long run. Chirinko and Wilson's finding thus suggests that investment by corporations in Georgia in the long run would increase by 1.72 percent if the rate was reduced from 6 percent to 4 percent. Chirinko and Wilson account for the effect of federal deductibility of Georgia's taxes, but not apportionment. Given the weighted average apportionment ratio of 49 percent, Chirinko and Wilson's results imply that a two percentage point reduction in Georgia's statutory tax rate would increase investment in Georgia by corporations in the long run by 0.84 percent.

Finally, it is possible that if Georgia reduced its corporate income tax, other states would follow suit if they thought Georgia's action would result in a loss of industry from their state. Such a reaction would reduce the magnitude of the incentive effect of a reduction in Georgia's corporate income tax rate.

### *Effects on Tax Revenue*

While cutting the tax rate to 4 percent is a reduction in the tax rate of one-third, the percentage reduction in revenue will be somewhat larger because of tax credits.<sup>16</sup> Using the corporation income tax returns for 2008, the estimated reduction in tax liability for tax year 2008 of reducing the tax rate to 4 percent would have been \$181 million, which is 35 percent of the \$514 million tax liability reported on the tax

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<sup>16</sup> To illustrate, consider the formula for determining tax liability: (income\*tax rate – credits). For income of \$1,000 and credits of \$10, the tax liability would be \$50 with a tax rate of 6 percent, and \$30 with a tax rate of 4 percent. The reduction in tax liability in this case is 40 percent, not 33.3 percent.

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returns.<sup>17</sup> This number is a static estimate in that it does not account for any behavioral response to the tax rate cut.

A reduction in the tax rate will likely increase economic activity in the state, although as suggested above, this effect is unlikely to be large. In addition, it will take time for any impact to be felt. With the reduced tax rate, firms may engage in tax planning to shift income to Georgia, which would offset the reduction in tax revenues. Furthermore, a reduction in the corporate income tax relative to the personal income tax has been shown to affect the choice of operating as a C-corporation rather than as a S-corporation or as a limited liability corporation (LLC) (see discussion in the Appendix). To the extent that some firms convert to C-corporations, tax revenue will increase, although with a corresponding decrease in personal income tax revenue.

### *Alternatives*

As noted above it is unlikely that cutting corporate tax revenue by 35 percent will have much effect on the level of economic activity in the state, particularly in the short run. Thus, the state might want to consider an alternative that would provide a larger increase in economic activity.

One alternative would be to impose a two-rate system. There are 13 states that have a multi-rate corporate income tax system. For example, Georgia could impose a 2 percent rate on taxable income of, say, \$250,000 or less and a 6 percent rate on taxable income above \$250,000. This option would provide a substantial percentage reduction in taxes for smaller firms and a smaller reduction for larger firms.<sup>18</sup> Smaller firms are less likely to be multi-state firms, and thus the effect of the tax rate reduction will be larger. Using the corporate income tax returns for 2008, we estimated the revenue loss for tax year 2008 from this option to be \$24 million which is a 5 percent reduction in corporate tax revenues. This is a static estimate; behavioral changes would affect the revenue estimate.

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<sup>17</sup> Tax liability is not the same as tax revenue since the payment of the tax liability will occur over time as corporations make estimated payments and obtain refunds.

<sup>18</sup> Large firms will have a reduction in their taxes since all firms would be taxed at only 2 percent on the first \$250,000.

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Table 10 shows the average reduction in tax liability by corporation size, as measured by federal taxable income, for both tax rate reduction options.

**TABLE 10. REVENUE EFFECT OF REFORM OPTIONS**

	-----Average Tax Savings-----	
	Reduce Rate to	Implement 2
	4 Percent	Percent Bracket
Federal Taxable Income ≤ \$0	\$115	\$82
\$0 < Federal Taxable Income ≤ \$100,000	\$200	\$372
\$100,000 < Federal Taxable Income ≤ \$500,000	\$920	\$1,341
\$500,000 < Federal Taxable Income ≤ \$1,000,000	\$1,438	\$1,253
\$1,000,000 < Federal Taxable Income ≤ \$10,000,000	\$2,890	\$1,203
\$10,000,000 < Federal Taxable Income	\$50,040	\$1,809

SOURCE: Authors' calculations using corporate return data from the Georgia Department of Revenue.

A second alternative would be to change the apportionment formula so that it would be smaller for corporations that have a large physical presence in Georgia. For example, consider the following apportionment formula:

$$(\text{Sales factor}) - 1/3 \times (\text{property factor}),$$

where the sales factor is the current apportionment ratio and the property factor is the ratio of the firm's property in Georgia divided by its total property. This would be the property factor that was used when Georgia had a three-factor apportionment formula. Of course, the property term in the above expression could be replaced by the average of the firm's property and employment shares in Georgia.

This formula would reduce the apportionment ratio, and thus the effective tax rate, for corporations that have investments in Georgia. Consider a firm whose sales and property are entirely in Georgia. Under the current corporate income tax the apportionment ratio is 1, and thus its corporate income tax liability would be its net income  $\times$  6 percent. With the alternative formula, the apportionment ratio would be 0.67 ( $= 1 - 1/3 \times 1$ ), and thus its corporate income tax liability would be its net income  $\times$  4 percent ( $= 0.67 \times 6\%$ ). In other words, this firm would have a reduction in its effective tax rate of 2 percent points. It would be the same as if the statutory tax

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rate was reduced to 4 percent, but the relief is targeted to those corporations with property in Georgia.

On the other hand, firms that have relatively little physical presence in Georgia would experience a small reduction in their effective tax rate. For example, consider a firm that has sales in Georgia but essentially no property. Suppose its sales factor was 0.5 and its property factor was 0.01. This firm's current effective tax rate is 3 percent ( $= 0.5 \times 6\%$ ). Under the revised formula the firm's effective tax rate would be 2.97 percent, and thus the reduction in this firm's effective tax rate would be 0.03 percentage points.

As noted above, for this firm a reduction in the statutory tax rate would provide no additional incentive to invest in Georgia. However, the revised apportionment formula provides an incentive for the firm to invest in Georgia rather than in another state. Investing in Georgia would increase the last term in the proposed formula, and thus reduce its effective tax rate.

Using the corporate income tax returns that were provided by the Department of Revenue, we estimated that if the state had implemented this apportionment formula for tax year 2007, the reduction in 2007 corporate tax liability would have been 31.4 percent.<sup>19</sup> Multiplying the 2008 corporate tax liability by this percentage yields an estimated reduction in tax liability of \$161 million. This compares to the estimated reduction in 2008 tax liability of \$181 million from reducing the rate from 6 percent to 4 percent.

### **B. Eliminate the Net Worth Tax**

Georgia might consider eliminating or revising the net worth tax. The principal argument for eliminating the net worth tax is that it is essentially a nuisance tax. In FY 2008, the average net worth tax liability was \$139 per filer.<sup>20</sup> The percentage of filers who paid less than \$10 was 8 percent, while the percentage of filers who paid less than \$25 was 67 percent. The maximum net worth tax liability is

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<sup>19</sup> We used 2007 tax returns since that was the last year for which the value of the property factor was reported.

<sup>20</sup> Authors' calculations using corporate return data from Georgia Department of Revenue. This calculation includes both SIC filers. The average NW liability for C-corporation filers was \$264 in 2008. The average NW liability for S-corporation filers was \$79.

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set at \$5,000. The cost to the corporation from filing a return and to the state in processing the return likely exceeds \$25.

The argument against eliminating the net worth tax is that it assures that all, or nearly all, corporations pay some minimal tax. In FY 2008, 61 percent of C-corporations paid no corporation income tax, but did pay a net worth tax. The average net worth tax paid by these corporations was \$267.<sup>21</sup> Some C-corporations may have no tax liability at the subsidiary level because the tax is paid at the parent level. This statistic is not computed at the S-corporation level because we do not have data of the tax liability of the S-corporation owners.

Rather than eliminating the net worth tax, the state could consider making it a true minimum tax for corporations. The state could increase the net worth tax rates, but allow corporations to deduct the net worth tax liability from its corporation income tax liability. This way, only corporations that pay little or no corporate income tax would pay a net worth tax. Another alternative would be to specify a minimum net worth tax. For example, a corporation would have to pay the net worth tax only if the tax liability exceeded, say, \$100. The objective of this recommendation is to eliminate the need to file a tax return when the tax liability is very small.

Eliminating the net worth tax would reduce tax revenue by a relatively small amount. Over the past 10 years, the net worth tax revenue has fluctuated between about \$30 million and about \$42 million a year. Given that the net worth tax liability is a relatively small tax, it is unlikely to have any measurable economic effects on firm behavior.

### **C. Throwback Rule**

One of the two major policy issues associated with the apportionment formula concerns the manner in which a state's formula treats sales made in a state in which the firm has no operations. Since U.S. law prohibits a state from taxing a firm that

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<sup>21</sup> Author's calculations using corporate return data from Georgia Department of Revenue. This calculation includes both S- and C-corporate filers. The average net worth liability for C-corporation filers was \$264 in 2008. The average net worth liability for S-corporation filers was \$79.

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does not have nexus in the state, sales in such states do not get taxed by any state and may serve to reduce the tax liability in other states by reducing the apportionment ratio of a firm. A throwback rule incorporates those sales into the apportionment formula so that receipts not taxed by other states will be taxed by the state in which the firm is located. Georgia does not currently have a throwback rule.

To illustrate the issue consider a firm that has plants in two states but sells in three states, with equal sales in all three states. Assume that all three states use a sales only apportionment formula. If we divide the sales in the two states in which the firm has operations by total sales, each of the two states would tax the firm on one-third of its profits. Thus, only two-thirds of the firm's profit would be subject to a state corporate income tax. The sales in states in which the firm has no physical presence are sometimes called "nowhere sales." As an extreme case, consider a firm that has nexus only in Georgia, but 90 percent of its sales are in other states. Georgia would tax only 10 percent of this firm's profits, while no other state would be able to impose taxes on the firm, assuming the firm does not have enough economic presence in any one state to establish nexus. To address this issue, some states require a firm to add nowhere sales to the firm's sales in the home state if the nowhere sales are shipped from the state. Continuing the above illustration, and assuming that the sales to the third state come equally from the two states in which the firm operates, then the sales factor for each of the two states in which the firm has nexus would equal 50 percent ( $= (33.3 + 16.7)/100$ ). Thus, each state would tax half of the firm's sales to the third state.

Twenty-three states have a throwback rule. The main argument for having a throwback rule is that it ensures that all of the income of the corporation is taxed by at least some state. In addition, the throwback rule decreases the ability of firms to reduce their corporate income tax by avoiding the establishment of nexus in states in which they make large sales.

However, there is a counter argument in the case. First, adding a throwback rule in Georgia does not ensure that all corporate profits are taxed since the firm can avoid the effect of the throwback rule by moving operations to states without throwback rules. Second, and more important, a throwback rule puts the domestic

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firm at a competitive disadvantage with respect to selling in states that do not have a corporate income tax. For those states without a corporate income tax, in-state businesses do not pay any corporate income tax, while firms located in a state with a throwback rule would see their income taxes increase as a result of sales made in the nontax state.

Adding a throwback rule to Georgia's apportionment formula would increase tax revenues since such a rule would increase the apportionment ratio for some firms but would not reduce the ratio for any corporation. Since the data necessary to estimate the revenue effect of adding a throwback rule are not readily available we are unable to provide a revenue estimate. Gupta, et al. (2009) use a panel data set consisting of all states with a corporate income tax over a 21-year period to estimate the effect of various state corporate income tax provisions on tax revenue. Their regression analysis implies that a throwback rule increases the state's corporate income tax revenue by 16 percent.

While most corporations would likely see a small to zero increase in taxes, it is possible that a throwback rule could have a substantial effect on taxes of some firms. Consider the extreme example presented above. With a throwback rule Georgia may impose a tax on 100 percent of the firm's profits rather than just 10 percent; this would be a 10-fold increase in the firm's tax liability.

### **D. Combined Reporting**

A corporation can create subsidiary corporations. This might be done for a variety of reasons, including the desire to segregate a risky venture from more secure operations, to house corporate management functions, to divide sales and distribution functions from production activities, to separate different product lines, etc. An issue concerns how such related corporate entities are treated for Georgia corporate income tax purposes.

The federal government allows corporations to file consolidated tax returns provided the corporations meet certain conditions, particularly regarding the degree of ownership. Under this type of reporting the firms file one consolidated return, after inter-company transactions are eliminated. The ownership rule requires that the

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parent company own at least 80 percent of the stock of at least one of the firms in the affiliated group and that there be at least 80 percent ownership of the other affiliated corporations among the affiliated corporations.

A state can choose to tax each subsidiary as a separate corporation, or tax them as unitary group. Combined reporting requires that the subsidiaries in a “unitary” business group file one combined tax return that includes the income (or loss) of all members of the group. Fox et al. (2009) provides extensive evaluation of combined reporting; the following discussion draws on their research.

There are two tests that states with combined reporting consider in deciding what constitutes the unitary group. First, there is an ownership requirement, similar to the federal ownership requirement. Second, the subsidiaries must be part of a “unitary” group, that is, part of the same business. The Supreme Court has ruled that ownership of a subsidiary company located in another state that is engaged in a different business does not satisfy nexus requirements that would allow the state to tax the profits of that subsidiary. Because of this ruling, states must define the unitary group on a more narrow basis than is required at the federal level.

In Georgia, affiliated corporations that file a consolidated federal income tax return must file separate state returns, unless the Commissioner authorizes the filing of a consolidated state return. Thus, Georgia does not, in general, allow combined reporting.

As of 2010, 22 states required combined reported, with several states adopting that requirement in the last few years, including Vermont (in 2006), New York (in 2007), Michigan (in 2008), and Massachusetts, West Virginia, and Wisconsin (in 2009) (Borens, Mata, and Kerner 2010).

There are two basic arguments for requiring combined reporting. First, combined reporting means that the corporate income tax is imposed on the firm defined as an economic or unitary entity, rather than on the firm established for administrative or tax reasons. Second, combined reporting reduces a firm's ability to engage in tax planning that shifts income to states with lower tax rates. While combined reporting reduces the firm's ability to engage in tax planning, there are



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possible advantages to a firm from filing a combined return, such as allowing the firm to offset operating losses in one subsidiary against profits in another.

There are three main issues that should be considered in deciding whether Georgia should adopt combined reporting.

### *Tax Sheltering*

As noted above, when firms can file separate returns, it is possible to set up tax shelters such as a passive investment company or to use transfer pricing to shift taxable income to lower tax states. Combined reporting is one way to eliminate these shelters. It is possible to at least reduce the advantage of such tax shelters by disallowing tax deductions for payments on the lease of intangibles and payments to REITs; Georgia does disallow such deductions.

### *Effect on Revenue*

An obvious factor to consider is whether requiring combined reporting will increase tax revenue. While combined reporting will reduce the ability of firms to use certain tax shelters, it does not follow that combined reporting will result in an increase in state tax revenue. Cline (2008) presents examples of situations in which combined reporting reduces revenue and examples in which it increases revenue. He points out that whether combined reporting increases or decreases tax revenue depends on the differences across subsidiaries in profitability per dollar of each apportionment factor. The revenue effect also depends upon whether the state allows a deduction of the payment for the rental of intangibles and payments to REITs. If such deductions are not allowed, there will be little addition tax revenue from closing tax shelters through the adoption of combined reporting.

Cline (2008) provides some information on existing state revenue estimates. When Minnesota adopted combined reporting in 1982, it estimated a 15 percent increase in revenue. However, after the first year, Minnesota did an analysis of tax returns and determined that combined reporting reduced revenue by 9 percent; this was due primarily to the conversion of unused separate entity losses into current loss offsets. Maryland estimated an increase in revenue of 3.0 percent, net of the expense add back that was previously adopted. New York estimated an increase in corporate

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tax revenue of 6.0 percent from requiring combined reporting. Fox, et al. (2009), using data from Vermont and New York, suggest that the adoption of combined reporting by those states might have increased revenue, but only by a small amount.

No attempt was made to estimate the revenue effect if Georgia were to adopt combined reporting. However, since Georgia already disallows deduction for lease payment for intangibles and for REITs, it is already collecting at least some of the revenue that would result from closing such tax shelters. This suggests that the additional revenue would not be large from the adoption of combined reporting.

### *Impact on Economic Development.*

As far as we know, there has been no rigorous analysis of the effect of combined reporting on economic development. Proponents of combined reporting claim that it would have a positive effect on economic development. Pro-business groups, such as the Council on State Taxation (COST), suggest the opposite. Cline (2008), in his report for COST, provides various types of evidence which shows that combined reporting would likely reduce economic development.

Finally, combined reporting increases the administrative complexities of the corporate income tax. Determining what operations constitute the unitary business is complex. Various standards have been proposed, and the criteria used vary across states. A related issue concerns the apportionment of income from a unitary firm, and in particular, which of the firm's businesses will be included in calculating the apportionment ratio. There are two approaches. The Joyce method includes only those businesses in the unitary group that have nexus in the state, while the Finnigan method includes all business in the unitary group, even if the business does not have nexus in the state. At present most states apply the Joyce method, though there is no definitive basis for this rule over the Finnigan rule.

### **E. Conforming to the Federal Income Tax Code**

One of the major differences between the federal and Georgia corporate income tax is the allowance for depreciation, that is, the treatment of the expense of non-financial assets. In general, the federal depreciation allowance is more generous than Georgia's. The allowable depreciation applies to all businesses, not just to

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corporations. In addition the IRC allows a special deduction for qualified production activities. Georgia has not fully adopted these three special provisions of the IRC.

There are two major IRC provisions relating to the depreciation deduction. The basic depreciation system used for federal and Georgia income tax purposes is the modified accelerated cost recovery system (MACRS). See Box 2 for an explanation of MACRS. The following discussion provides the federal special depreciation provisions; however, we do not discuss many of the details.

*Section 179.* Section 179, which refers to a section of the IRC, was initially adopted in 1958 and allows for the accelerated depreciation of certain assets up to some maximum value. The maximum has varied over time. The provision was designed to be particularly beneficial for small businesses. Firms elect to take the Section 179 option when the asset is placed in service; if the firm does not take the Section 179 option in the year of eligibility, it cannot elect the option later with respect to the depreciation of that asset.

For 2011, 100 percent of eligible property can be expensed, up to a maximum of \$500,000 for federal tax purposes. The allowable deduction was phased out dollar-for-dollar of the amount of eligible equipment that exceeds \$2 million. Thus, if the firm has invested \$2.1 million in eligible assets, its Section 179 depreciation for that year was \$400,000 (which is equal to \$500,000 less the \$100,000 in excess of \$2 million).

Section 179 applies to new and used tangible personal property (for example, equipment, office furniture, computers, “off-the-shelf” computer software, livestock, and business vehicles) acquired for business use and placed in service. Certain real property, for example, leasehold improvements to non-residential property and improvements to existing restaurant and retail spaces, are eligible up to a maximum of \$250,000. Intangible property, for example, a patent, is not eligible for Section 179 deduction. Land is not depreciable under any IRC depreciation method.

The deduction must be taken in the year the equipment is placed in service. The deduction cannot exceed the firm's tax liability for that year; for the federal income tax the firm can carry forward any unused Section 179 deduction.

**BOX 2**

**Modified Accelerated Cost Recovery System (MACRS)**

While total depreciation over the life of an asset will equal the total value of the asset regardless of the depreciation schedule, the timing of the depreciation deductions has a significant effect on the present value of the tax consequences from depreciation. For example, consider a \$1 million piece of equipment and two depreciation schedules. Under the first schedule the firm is allowed to expense the asset, that is, depreciate it entirely in the first year, while under the second schedule the firm depreciates 10 percent of the asset each year for 10 years. With the first depreciation schedule (expensing) the firm can take a first year deduction of \$1,000,000. With the second schedule, the firm is only allowed a first year deduction of \$100,000. Because the deduction must be taken over a 10 year period, the value of the deduction to the firm is reduced compared to the case where the deduction can be taken all at once in the first year.

MACRS is the name of the system of depreciation that is used for federal and Georgia income tax purposes, both for corporations and non-corporate businesses. MACRS applies to most property other than land, net of Section 179 and bonus depreciation deductions (these are discussed in the text). MACRS allows an asset to be depreciated faster than under the straight-line depreciation method. Straight-line depreciation allows a deduction of the same amount each year over the asset's useful life. Real property is depreciated using the straight-line method. Under MACRS property is assigned a recovery period and a depreciation schedule. MACRS uses either 200-percent or 150-percent declining balance method depending on the type of asset.

Under the straight line method, the depreciation deduction on a \$1,000 asset with a useful life of 10 year would be \$100 per year. Under 200-percent (or double) declining balance, the depreciation allowance for a given year is 20 percent of the un-depreciated balance, where 20 percent is double the straight line rate of 10 percent. Thus, for a \$1,000 asset the depreciation would be \$200 in the first year, \$160 (20 percent of \$800) in the second year, \$128 (20 percent of \$640) in the third year, etc. Note that under 200-declining balance, the depreciation deduction gets smaller each year, but never gets to zero.

There are two modifications that the IRC makes to the 200-percent declining balance. First, the MACRS assumes that the asset is put in place in the middle of the year, so the depreciation is only 10 percent in the first year. Second, the calculation of the deduction switches to the straight-line method in the tax year in which the straight-line deduction on the un-depreciated amount would be larger than continuing the 200-percent declining-balance method. The following table shows the depreciation allowance each year and the present value of the tax reduction for the three methods, straight line, 200-percent declining balance, and MACRS, for a 10-year asset purchased for \$1,000. We also show the depreciation allowance if the asset was eligible for 100 percent and 50 percent bonus depreciation (see text for an explanation). It is assumed that the asset was purchased in the middle of the first year.

*Box 2 continues next page...*

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### BOX 2 (continued)

With 200-percent declining balance, the depreciation deduction will continue beyond the 11<sup>th</sup> year since at the end of the 11<sup>th</sup> year there is still nearly \$97 to be depreciated. (The present value for the 200-percent declining balance reported in the table is for the total depreciation, not just for the first 11 years.)

#### DEPRECIATION

Year	Straight Line	200-Percent Declining Balance	MACRS	100 Percent Bonus Depreciation	50 Percent Bonus, and then MACRS
1	\$50.00	\$100.00	\$100.00	\$1,000.00	\$550.00
2	100.00	180.00	180.00		90.00
3	100.00	144.00	144.00		72.00
4	100.00	115.20	115.20		57.60
5	100.00	92.16	92.16		46.08
6	100.00	73.73	73.73		36.87
7	100.00	58.98	65.54		32.77
8	100.00	47.19	65.54		32.77
9	100.00	37.75	65.54		32.77
10	100.00	30.20	65.54		32.77
11	50.00	24.16	32.77		16.38
Total	\$1,000.00	\$903.36	\$1,000.00	\$1,000.00	\$1,000
Present Value at 12 percent	\$534.75	\$591.48	\$608.40	\$1,000.00	\$750.64

Georgia limited the allowable value of Section 179 for 2011. For Georgia income tax purposes firms could expense a maximum of \$250,000, with the phase out starting at \$800,000. These were the federal income tax parameters in 2009; Georgia did not adopt the recent increase in the allowable Section 179 deduction enacted in 2010 by the federal government.<sup>22</sup>

*Bonus Depreciation.* Bonus depreciation allows a business to expense a certain percentage of the cost of its depreciable property beyond the Section 179 deduction limits. Bonus depreciation was first enacted in 2001, with the bonus rate

<sup>22</sup> The federal government identified certain areas as special zones that qualify for increased Section 179 deduction. These zones include the New York Liberty Zone, Special Enterprise and Renewal Community Business Areas, and the Gulf Opportunity (GO) Zone. For firms located in either of the first two zones, the firm is allowed an additional \$35,000 in Section 179 deduction and an additional \$100,000 for the GO Zone. Georgia does not allow the additional Section 179 deductions for the New York Liberty Zone but does recognize the increased deductions for the other zones.

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being 30 percent. Property acquired between September 8, 2010 and January 1, 2012 and put in use by January 1, 2012, was eligible for 100 percent bonus depreciation. Thus, for eligible property, a firm can expense 100 percent of the cost of the property. Under current law the bonus depreciation level is 50 percent in 2012 and is scheduled to fall to zero in 2013. To be eligible, the property must be new and must have a depreciation recovery period of 20 years or less, or be water utility property, computer software, or certain leasehold improvements.<sup>23</sup>

Georgia has not adopted any of the bonus depreciation provisions.

To illustrate how Section 179 and bonus depreciation work, consider the purchase of \$2,300,000 in depreciable equipment, which is eligible for both Section 179 and bonus depreciation. The Section 179 deduction equals \$200,000 (= \$500,000 less the \$300,000 over the \$2 million maximum). With 100 percent bonus depreciation, the firm can expense all \$2,300,000. With 50 percent bonus depreciation, the firm can take \$200,000 under the Section 179 deduction and \$1,050,000 in bonus depreciation, which is 50 percent of \$2,100,000. Furthermore, the firm can take an additional depreciation deduction, using the applicable depreciation schedule, on the \$1,050,000 that is not expensed.

Singham and Johnson (2011) provide estimates of state revenue losses for the first year from conforming to federal bonus depreciation for the states that generally conform to federal depreciation provisions (see Table 11). For Georgia, the analysis prepared for conformity legislation in 2011 yielded an estimated revenue loss for the first fiscal year of about \$250 million.

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<sup>23</sup> In past years, the IRC allowed increased bonus depreciation for property that was put in place in certain geographic areas.

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**TABLE 11. ESTIMATED STATE REVENUE LOSS FROM CONFORMING TO FULL EXPENSING**

State	Revenue Loss (millions)	State	Revenue Loss (millions)
Alabama	\$239	Nebraska	\$88
Colorado	226	New Mexico	39
Delaware	77	North Dakota	43
Florida	629	Oklahoma	143
Illinois	1,009	Oregon	270
Kansas	198	Pennsylvania	833
Louisiana	191	South Dakota	9
Missouri	190	Utah	159
Montana	55	West Virginia	166

Source: Singham and Johnson (2011).

*Section 199, Domestic Production Deduction.* Another significant federal tax provision that Georgia has not adopted is the domestic production deduction. The federal government had a series of tax breaks designed to encourage exports by American manufacturers. However, the World Trade Organization ruled that the “extra-territorial income” (ETI) provision violated U.S. trade treaties. To replace this provision Congress, in 2004, adopted the domestic production deduction. The domestic production deduction is much broader than the ETI. The deduction is open to any firm, not just to corporations.

The deduction equals the firm’s qualified production activities income (QPAI) less the qualified production activities expenses times 9 percent. (The allowable deduction started at 3 percent, increased to 6 percent for tax year 2007, and to 9 percent beginning in tax year 2010.) Qualified production activities includes manufacturing, but also includes other production activities such as architectural and engineering services, construction, film making, coffee roasting, publishing, mining and oil extraction, and electricity and natural gas production.

When the deduction was first adopted by the federal government, Georgia decoupled it from the state corporate and personal income taxes. Currently, 22 of the 47 states with a corporate income tax have decoupled.

We do not have a current estimate of the revenue loss if Georgia were to adopt the Section 199 provision today. The Joint Committee on Taxation estimates that for 2011 the provision reduced federal corporate income tax revenue by 3.1

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percent. For Georgia, 3.1 percent of 2011 corporate income tax revenue would have been \$20.8 million.

As noted above, adopting these IRC depreciation provisions would result in a substantial reduction in revenue, both corporate income tax and personal income tax since these provisions apply to all firms, not just corporations. On the other hand, these provisions would increase the incentive for firms to invest. However, the benefit to the firm of the increased depreciation allowances would be obtained regardless of which state the firm located its investment in plant and equipment.



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## **Appendix A. Literature Review on Economic Development Effects of Taxes**

This Appendix contains a brief review of the literature that provides empirical evidence on the effect of various provisions of the corporate income tax on state economic development. The review focuses on the effect of tax rates and is organized around alternative measures of economic activity. The last section considers the economic effect of changes in the apportionment formula.

### **Firm Organization**

Goolsbee (2004) matches data from the Department of the Census on the organizational form by three-digit SIC code in the retail sector with a state's respective corporate income tax rate in 1992. Using this cross-sectional state corporate income tax (SCIT) variation, the results suggest that increasing the corporate tax rate by 0.10 percentage points reduces the corporate share of firms in a state by about 0.25 percentage points and the corporate share of sales and employment by 7–15 percent. Another study by Luna and Murray (2010) examines how state tax policy affects business entity organizational form, in particular, the number of corporations, partnerships, and the overall share of corporations in each state. The authors use state-level IRS data for the years 1997–2008 as well as SCIT rates from the *CCH State Tax Handbook* to conduct the analysis. The authors find that relatively high corporate income tax rates only slightly reduce the share and number of firms conducting business as corporations. Specifically, they estimate that a 10 percent increase in the corporate income tax rate would yield a 0.5 percent statistically significant reduction in the share of returns filed by corporations.

### **New Firm Birth**

Relatively few recent studies have attempted to estimate the effect of state taxes on the number of new firm births. Carlton (1983) uses Dun and Bradstreet data on new branch plant formations from 1967–1971 and detailed Metropolitan

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Statistical Area (MSA)-wide data to estimate, among other things, the effect of state taxes on plant formation. Although Carlton's tax variable is a weighted average of state corporate and income tax, his findings suggest that state tax variables have a very small and always statistically insignificant impact on firm birth. A similar study was conducted by Bartik (1985). Bartik uses similar data for years spanning 1972–1978 to estimate the probability a new firm will locate in a specific state. His findings indicate that a 10 percent increase in a state's corporate income tax rate results in a 2–3 percent decline in the number of new plants. The author does emphasize that differences in unionization across states play a larger role in determining new firm location in the United States rather than state tax policy.

Papke (1991) extends the analysis on new firm location, but applies a reduced form Poisson count model accounting for state unobserved heterogeneity to a cross-sectional time series panel (linked longitudinally by firm) of 22 states and five manufacturing industries from 1975 to 1982. Data for new firm births come from the U.S. Establishment and Enterprise Microdata File of the Small Business Administration using 3-digit SIC codes. The author also extends the literature by estimating the impact of an effective corporate tax rate rather than the statutory tax rate from earlier studies. This more accurately captures all levels of tax faced by corporations (deductions, depreciations, etc.). Her estimates indicate that the elasticity of new manufacturing plant births with respect to the effective corporate tax rate can range from 1.6 to 15.7. These estimates are highly dependent on the type of industry, so generalizations to all employment sectors should not be made.

### **Investment**

Another major component in the analysis of state corporate taxation is its impact on local investment. Several economists have made attempts to quantify how different SCIT measures affect different measures of local investment. An older study by Plaut and Pluta (1983) uses pooled data for the 48 contiguous

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states to test the effect of, among other relevant variables, state and local taxes and expenditures on measures of industrial growth. Although they find that investment decisions by firms are indeed influenced by an overall “business climate” measure that includes several different variables, the direct measure of statutory SCIT was not found to be a statistically significant determinant of investment decisions. However, a later study that includes measures of state and local taxes as well as measures of state and local tax expenditures finds that when both of these measures are accounted for, SCIT is found to have a statistically significant effect on the amount of investment in the state (Mofidi and Stone 1990). Specifically, these authors examine data for all fifty states over the period from 1962 to 1982 and include several demographic, state, and time controls. Their results suggest that, at the sample mean, an increase of 1 percentage point in the ratio of taxes to personal income that is devoted to transfer-payments is associated with a decline of about 9 percent in net investment. The authors conclude that it is important to control for variations in government expenditure patterns across states when attempting to estimate the impacts of state and local taxes on economic growth.

A more recent study examines how variations in states’ corporate income tax regimes affect new business capital investment (Gupta and Hoffman, 2003). Specifically, the authors examine how investment levels differ among states with differing statutory SCIT rates and apportionment formula factor weights. They use state-aggregated panel data from 1983 to 1996 (Annual Survey of Manufactures and other Census Data). Pooled regression and fixed-effects analysis provides evidence that the SCIT burden on property (a measure including both SCIT statutory rate and apportionment formula factor weights) has a statistically significant negative effect on new capital expenditures by manufacturing firms. The authors conclude that although their results are statistically significant and robust across and within state comparisons, the magnitude of these impacts are modest and any economic significance may be negligible.



### Foreign Direct Investment

Local and state officials are also concerned with the amount of foreign investment occurring in their respective jurisdictions. Some studies have attempted to disentangle the effects of SCIT rates on different levels of foreign investments. One study by Ondrich and Wasylenko (1993) use a pooled cross-section and time-series data set for states and individual manufacturing plant location choices for the period 1978 to 1987 (from the International Trade Administration) to examine the factors that influence the state location decisions of new foreign plants. The authors apply a multinomial logit model to the data and find evidence suggesting that states that decrease their SCIT revenues as a percentage of state personal income have an increased probability of foreign firms locating in their state.

A study by Hines (1996) also examines the influence of SCIT and foreign direct investment and finds similar results to those found by Ondrich and Wasylenko (1993). In particular, Hines examines the effect of tax rates on the distribution of foreign direct investment (FDI) within the U.S. but makes a distinction between foreign countries that receive home-country credits for income taxes paid in the U.S. versus all other countries that do not receive such credits. The author uses cross sectional data from the Bureau of Economic Analysis from 1987 to perform his analysis. His results suggest that high state tax rates have a significantly negative effect on local investment by firms overseas. Specifically, his estimates indicate that state corporate tax rate differences of 1 percent are associated with differences of 9–11 percent between the investment shares of foreign-tax-credit investors versus all others. Hines emphasizes that these estimates are rather large and that responses of this magnitude are unlikely to materialize if one considers the nature of equilibrium in the local capital markets.

### Employment

Perhaps of biggest concern to policy makers and economists is the impact tax policies have on local employment levels. Although still largely inconclusive, the vast majority of the literature on the effects of SCIT concerns how varying rates determine levels of state employment. An early study by Wasylenko and McGuire (1985) examined state employment growth in six major industrial sectors (both manufacturing and non-manufacturing industries) focusing on the period from 1973 to 1980 when there was considerable variation in state employment levels. In addition to nominal and effective corporate income tax rates, the authors also include several other control variables that are relevant determinants of firms operating costs and profitability. Overall, the study finds that location determinants (firm employment) vary by industry. Energy and labor costs are significant factors in determining state employment levels as are state expenditures on education. However, the authors did not find SCIT levels to have any statistical significant impact on state employment levels.

Mofidi and Stone (1990) also examine how different tax levels in conjunction with public expenditures affect state employment levels. They use manufacturing firm data from all fifty states over the period from 1962 to 1982 and obtain employment (full time equivalent workers in manufacturing) data from the *BLS Handbook of Labor Statistics*. Their estimates indicate that an increase of 1 percentage point in the ratio of taxes to personal income that is devoted to transfer-payments leads to a statistically significant decline of about 5 percent in manufacturing employment. In contrast to other studies, they do find a significant impact of SCIT on employment, but specifically when taxes are used for non-transfer type public expenditures (health, education, highways etc.). The authors emphasize the importance of considering both public revenues and expenditures when estimating impacts of fiscal variables on employment and other local economic development.

An earlier study by Plaut and Pluta (1983) also attempted to estimate the impact of taxes on manufacturing sector employment levels across different

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states. The authors find that poor business climate and high state tax effort (composite tax measures) seem to have a negative effect on state manufacturing employment growth. However, state corporate taxes do not seem to have any significant effect on state employment growth. The authors do point out that there is a strong correlation between local property taxes and industrial growth suggesting that local taxes may not be a deterrent to growth if the benefits are funding desirable public expenditures that are valued by firms. This is consistent with other studies that find it important to consider both revenues and expenditures when analyzing impacts of fiscal variables on employment growth.

Other studies have attempted to examine firm location and employment growth within metropolitan areas due to differential business tax rates. A study by Wasylenko (1980) examines the location decision of firms (construction, manufacturing, wholesale trade, retail trade, finance, insurance and real estate, and services) that moved from Milwaukee to its suburbs between 1964 and 1974. The author finds evidence that effective municipal property tax rates are a significant determinant of location decisions for wholesale trade and manufacturing firms relocating between suburbs throughout this period. A relatively newer study examined business tax rate differentials and its effect on employment in the Washington DC metropolitan area (Mark, McGuire, and Papke 2000). The authors use data spanning from 1969–1994 and estimate a fixed effects model for their analysis. The authors find that higher levels of personal property tax and sales tax are associated with lower employment levels. The results also indicate that corporate income tax rates have no significant effects on employment levels although the variation of this variable is quite limited in their analysis.

Carroll and Wasylenko (1994) apply a switching regression model to test whether a structural change occurred in the relationship between state corporate tax and state economic activity and employment. Looking at data from 1967–1988 the authors find that fiscal variables did have substantial effects on state employment levels during the 1970's, particularly in the manufacturing

employment sector. Similar analysis indicates that for the fiscal variables no longer have any statistical influence on manufacturing sector employment levels in the 1980's. Although not directly tested in their study, the authors hypothesize that increasing globalization and foreign direct investment may have decreased the significance of local fiscal variables in the later period of the study. The authors also note that fiscal variables were not significant determinants for employment in either period in the non-manufacturing sector.

A recent study by McCarty and Bruce (2010) applies panel regressions using state-level panel data for 1996 through 2007 to analyze the effect of variations in SCIT policies on employment and other measures of economic activity. Their analysis accounts for varying apportionment formulas, throwback rules, and combined reporting rules as well as interactions between these and corporate tax rates to assess interdependencies. In particular, the authors find that the top corporate tax rate has a negative effect on personal income and non-farm employment in states with throwback rules but they find no effect in states without throwback rules. The authors emphasize the importance of examining the impacts of SCIT policies through its interaction with other policy variables (throwback rules) in order to understand the complexities and interdependencies fiscal policies have on economic activity.

### **Apportionment Formula Studies**

The traditional apportionment formula uses a three-factor formula, giving equal weight to each factor: property, payroll, and sales. Some recent studies have examined how different weighting schemes affect economic activity in the various states. Goolsbee and Maydew (2000) use panel data from 1978–1994 to examine how differential weighting in the apportionment formula affect state-level employment. Their results suggest that switching from one-third to one-quarter payroll weight increases manufacturing employment by 1.1 percent. Another study by Edmiston and Arze (2006) uses individual firm level data provided by a population of corporate income tax returns from the State of

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Georgia to estimate the economic effects of changes in the state corporate income tax apportionment formula. Their estimates indicate that a 25 percent reduction in the factor weight of the payroll and property in the apportionment formula led to increases in Georgia payroll and property of 1.98 percent and 2.08 percent respectively. Their estimates also account for a 50 percent increase in the formula weight for the sales portion of the tax. According to their estimates, this increase leads to a decrease in sales for the average multistate corporation in Georgia of approximately 6.45 percent.

A more recent study by Gupta et al. (2009) uses aggregate state-level panel data from 43 different states with a SCIT spanning 1982–2002. They estimate fixed-effects regression models while also using a two-stage least square approach to account for the endogeneity of apportionment formula weights and tax rates in SCIT revenue regressions. Their estimates suggest that states with a double-weighted (50 percent) sales factor collect on average 16–18 percent lower SCIT revenues than states with an equal weighted formula. Their results also indicate that a one percentage point increase in the statutory tax rate is associated with 11–12 percent higher SCIT revenues; however, there is almost no mention of the effects on state employment. Edmiston (2002) analyzes differential weighting schemes using an eight-region, eight-sector applied general equilibrium model. His simulations suggest that adopting an apportionment formula solely based on sales may have substantial positive economic development impacts in the very long run. However, his simulations also show that once all states adopt this type of formula, the competitive economic development landscape changes where the advantage for early adopters is significantly reduced. Edmiston also points out that the impact on state revenue tends to be greater in magnitude and felt almost instantly while economic development impacts are less substantial and tend to unfold in the longer term.

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