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Tax Reform and Modernization in Georgia

The First Steps

Special Report
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Sarah Beth Coffey
sarahbethgbpi@bellsouth.net

Erin Schwartz
eringbpi@bellsouth.net

Alan Essig
alangebpi@bellsouth.net

Executive Summary

Georgia has a state tax system that is antiquated and out of touch with the modern economy of the 21st century. How do we reform and modernize the tax structure to ensure that the tax system is fair and equitable, that it is relevant to the modern economy, and that it raises the revenues necessary to meet the education, healthcare, and public safety needs of the 5th fastest growing state in the country, a state that aspires to be “world class”?

- Expanding the sales tax to include certain household services would raise additional revenue of at least **\$600 million per year** *without* raising the sales tax rate.
- Closing the combined reporting corporate loophole would increase revenues by at least **\$500 million over ten years**. Although there are no reliable estimates, closing the throwback rule corporate loophole would also substantially increase revenues.

Expanding the sales tax base to include various household services and strengthening the corporate income tax to assure compliance through closing two loopholes brings fairness, equity, and economic reality to the current tax structure. Expanding the sales tax base to include services would do much to reverse the erosion of the sales tax by acknowledging the economic realities of the continued movement towards a service economy. The corporate income tax is a vital part of the overall tax structure and helps assure that those entities that benefit from government services contribute to help pay for such services. Closing corporate tax loopholes helps assure that compliance with the tax is fair and equitable.

In addition to the state’s interest in developing a fair and equitable tax system that is sensitive to the modern economy, Georgia also has an interest in adequately funding services such as healthcare, education, public safety, and important social services such as child protection. Such services are vitally important to Georgia’s economic development efforts. Revenues generated from closing corporate tax loopholes and broadening the sales tax base could help restore austerity cuts to the K-12 education formula; rebuild the Revenue Shortfall Reserve; make dramatic inroads in eliminating the waiting lists for the developmentally disabled programs and the waiting lists for Community Care programs for the elderly; fully fund the Hazardous Waste and Solid Waste Trust Funds; restore Medicaid hospital cuts, cuts to PeachCare, and cuts to public health departments; increase mental health services to children and dramatically increase family foster care per-diem rates; as well as fill state trooper vacancies and double the funding for the Department of Economic Development “Tourism Marketing” program.

Expanding the sales tax to include services and closing corporate tax loopholes should be the first step in an overall tax reform effort. Comprehensive tax reform might include broadening the personal income tax brackets and increasing the personal exemptions and standard deduction for tax relief for working families; review of sales tax exemptions; review of corporate tax credits; and increase of the motor fuel, alcohol, and tobacco taxes.

Budget reform and tax reform need to be linked. The Governor’s budgeting philosophy of outcome and performance based budgeting should be discussed in the same conversation as tax reform.

- What should state government be doing?
- What are the policies needed to be successful?
- What will it cost to successfully implement such policies?

We then need to develop a fair and equitable tax system that will allow the state to raise the necessary revenues needed to accomplish the agreed upon policy goals.

Introduction

Georgia has a state tax system that is antiquated and out of touch with the modern economy of the 21st century. As a result, Georgia revenues as a percent of personal income are at their lowest level in 25 years.¹ Other than spending on education (mostly due to teacher salary increases) state spending during the 1990's barely kept up with inflation and population growth.² In addition, the most recent recession has led to budget cuts totaling approximately \$1.7 billion. The traditionally low-level of state expenditures, combined with the budget cuts since FY 2002 have resulted in a pent up demand for vital government services. Meeting this demand proves difficult with the current outdated revenue structure.

How do we reform and modernize the tax structure to ensure that the tax system is fair and equitable, that it is relevant to the modern economy, and that it raises the revenues necessary to meet the education, healthcare, and public safety needs of the 5th fastest growing state in the country, a state that aspires to be "world class"?

This report highlights the first steps that can be taken to reform and modernize the Georgia tax system. The first section of this report discusses the sales tax, and in particular why the sales tax base should be expanded to include certain services. The second section of this report discusses the corporate income tax, why the corporate income tax should be a part of an overall tax structure, and how Georgia can strengthen the corporate income tax by closing loopholes and therefore enhancing compliance. The report concludes with examples of gaps in state spending that could be filled through additional revenues, and a discussion of various other tax reform options.

Sales Tax

There has been a sales tax in Georgia for nearly half a century. Since its enactment in 1951, it has proven to be a significant revenue earner for the state. Also, according to a recent survey by the Fiscal Research Center at Georgia State University, Georgians picked the sales tax as the "most fair" tax.³ So, why talk about sales tax reform? Despite its popularity, the sales tax earnings as a portion of total household consumption have declined over the past decade. By extending the sales tax to services, Georgia can avoid further decline in the sales tax and ensure its viability as Georgia continues to shift towards a service-oriented economy.

History and Trends

The historical circumstances surrounding the enactment of the sales tax caused states to levy the tax on tangible goods rather than services. In 1930, Mississippi passed the first sales tax in response to the Great Depression. Due to the dramatic drop in the property tax receipts, other states quickly followed. With the goods driven economy of the 1930s and 1940s, a sales tax on goods was the logical method of raising much needed revenues. It was easy to identify taxable goods, and it minimized the possibility of tax evasion. By the start of World War II, twenty-three states had enacted a sales tax on goods.

Today, the economy has shifted nationally to being more service oriented. The Center on Budget and Policy Priorities reported that the household consumption of services exceeded the household purchase of goods in 1982, and the gap has continued to increase (see Figure 1).⁴ However, services

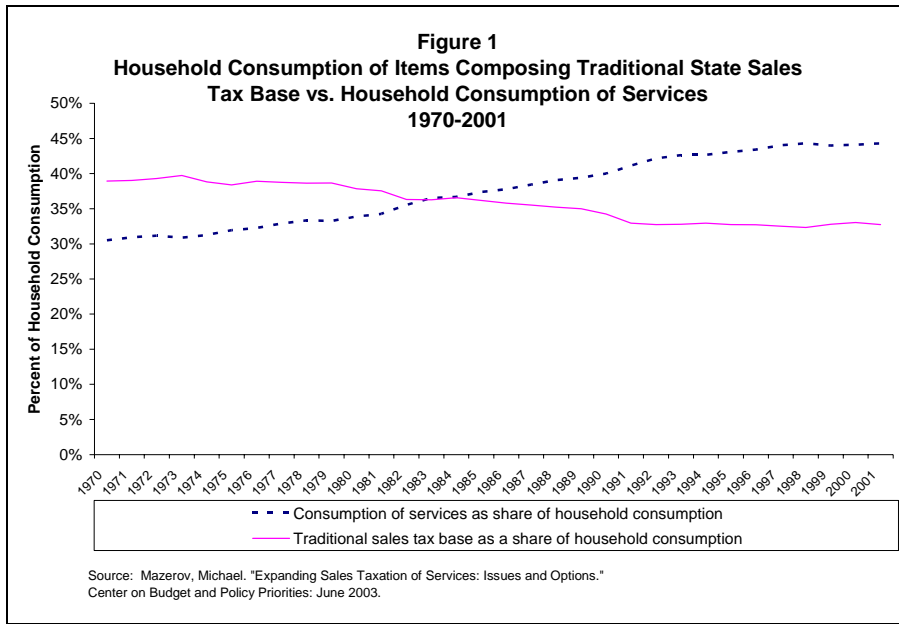
¹ Essig, Alan. "Price of Government." Georgia Budget and Policy Institute. November 2004.

² Essig, Alan. "Twelve Years of Budget Growth: Where Has the Money Gone?" Georgia State University Fiscal research Center. Report No. 84, July 2003.

³ Sjoquist, David. "Public Opinion on Issues of Tax Fairness." Fiscal Research Program. Report No. 59, June 2001.

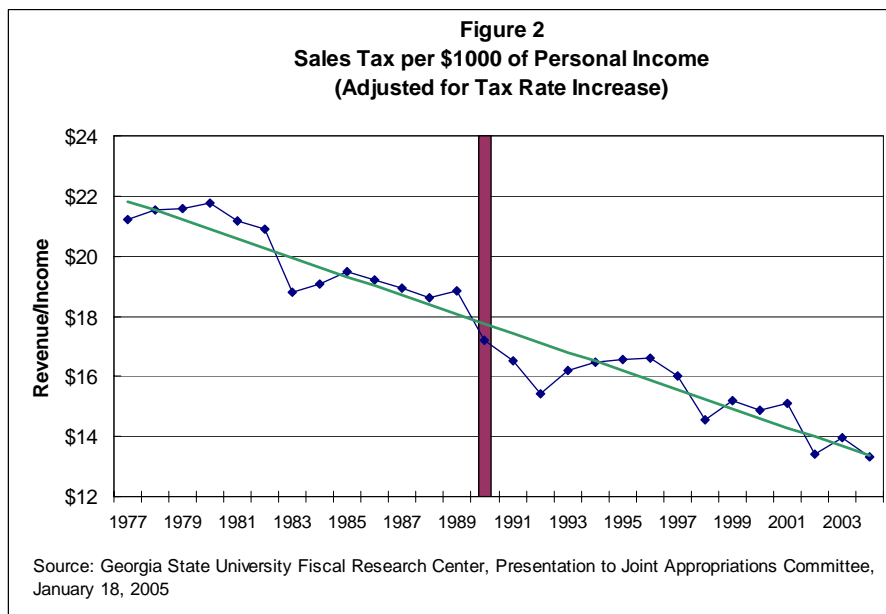
⁴ Mazerov, Michael. "Expanding Sales Taxation of Services: Issues and Options." Center on Budget and Policy Priorities: June 2003.

remain largely exempt from sales tax with states only taxing an average of one-third of the 164 potentially taxable services named by the Federation of Tax Administrators.⁵



Georgia's history follows the same pattern as that of the nation. In 1951, the General Assembly enacted the Georgia general sales tax on goods at 3 percent with services being exempt, except when specified as taxable. The 3 percent rate held steady until it was raised to 4 percent in 1989.⁶ The current 4 percent sales tax gives Georgia one of the lowest rates in the Southeast. In addition to its relatively low rate, Georgia taxes a mere 34 out of 164 services.⁷

In Fiscal Year 2004, Georgia collected \$4.8 billion in sales tax revenue, or 33 percent of all general funds collected. Although \$4.8 billion is a significant portion of state revenues, the sales tax revenue as a percentage of personal income has been steadily declining overtime (see Figure 2).



⁵ Federation of Tax Administrators. "Sales Taxation of Services: 1996 Update," Research Report No. 147: April 1997.
⁶ For more information on the Georgia sales tax, see Bhal, Roy and Hawkins, Richard. "The Sales Tax In Georgia: Issues and Options." FRP Report No. 1. Georgia State University, Fiscal Research Center: October 1997.
⁷ Supra Note 5.

A number of exemptions and changes in the economy have caused this erosion of the sales tax base. Sales tax exemptions, other than food, adopted since 1987 have cost the state over \$80 million.⁸ The 1996 exemption of food cost Georgia \$642 million.

In addition to exemptions, the shift from a commodity to a service-oriented economy presents a substantial obstacle for the sales tax. Since Georgia only taxes 34 out of a possible 164 taxable services, the percentage of the economy covered by the sales tax has declined from 69% in 1974 to 58% in 1994.⁹ The Georgia economy will continue to move from manufacturing to services; and thus, the goods-focused sales tax will continue to decline as a percentage of the economy.

Finally, internet purchases (e-commerce) have also placed a toll on sales tax revenues. Since federal law precludes Georgia from taxing e-commerce, the estimated loss to Georgia in sales tax revenue for e-commerce in FY 2003 was \$270 million. This loss will increase to an estimated \$400 million by 2008.¹⁰ While this is an important issue to be addressed for sales tax, resolving it requires federal legislation, and will not be discussed within the scope of this paper.

Number or Services Taxed Out of 164 Service Categories	
West Virginia	109
Texas	78
Tennessee	71
Mississippi	70
Arkansas	65
Florida	64
Louisiana	60
Maryland	39
Georgia	34
Alabama	32
Oklahoma	32
South Carolina	32
Missouri	28
North Carolina	28
Kentucky	26
Virginia	18

Source: Federation of Tax Administrators, 1997.

The Sales Tax: Advantages and Disadvantages

While the sales tax base has experienced erosion in the past decade, there remain several advantages to raising revenues through personal consumption. The advantages of a sales tax, as listed below, make a strong argument in favor of keeping and reforming the tax.

- *Transparency:* The transparency of the tax allows all taxpayers to see exactly what is taxed – the retail price – and by how much.
- *Simplicity:* Sales tax presents a simple solution for the taxpayer since there are no tax returns to file. The bottom line is that an item is either taxable or it is not.
- *Pervasiveness:* Most states use the tax. The popularity of the sales tax demonstrates that it is an accepted method of raising revenue across the U.S.
- *Masked Potential:* The low rates hide the significant revenue generating power of sales tax.
- *Impartiality:* It touches virtually all residents as well as tourists visiting the state. Unlike property tax and income tax, all taxpayers pay the same rate of sales tax on all taxable items.
- *Administrative Ease:* Changing the sales tax rate or adding the exempt services to the base are relatively easy since the administration and personnel for administering the sales tax are already in place.

Although sales tax does offer many benefits, it presents a few disadvantages to be considered as well.

- *Regressive Nature:* It places a higher sales tax burden on low-income households who tend to spend greater proportions of their budgets on taxed goods.

⁸ Georgia State University Andrew Young School of Policy Studies Fiscal Research Program. 2002. "Revenue Implications for Georgia Tax Changes since 1987".

⁹ Supra Note 5; Supra Note 6.

¹⁰ Bruce, Donald and Fox, William. "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004." The University of Tennessee Center for Business and Economic Research: July 2004.

- *Horizontal Inequity*: Refers to different treatment of families with similar incomes. Specifically, one family chooses to purchase a tax exempt service versus another family buying a taxed good.
- *Pyramiding*: If business-to-business purchases are subject to the sales tax, then businesses can pass their tax cost onto the consumer. This layering of sales taxes is known as pyramiding.
- *Volatility*: Sales taxes are often volatile and unstable, especially if the sales tax base is narrow and does not include food.

Placing the Sales Tax on Services

In the previous discussion, the sales tax exhibited both a decline as a percent of household consumption and several inherent weaknesses including a regressive nature, horizontal inequity, and volatility. In order for the sales tax to remain a vital part of our tax system, Georgia must ensure a robust consumption tax while addressing the weaknesses of the tax. The taxation of services offers one such method by broadening the tax base, and thereby, reversing the declining revenues, decreasing the volatility, and making the process more horizontally equitable.

Taxing services involves broadening the base to which the sales tax applies. The sales tax base is the goods and services subject to the tax. The amount of revenue generated by a sales tax depends on the size of this base as well as the percentage of the tax. As mentioned previously, Georgia's sales tax base has been slowly eroding due to the shift from a goods-based economy to a service-oriented economy. Whereas a sales tax that includes mostly goods covered 69% of the economy in 1974, the shifting market led to only 58% of Georgia's more service-based economy being taxed.¹¹

Georgia taxes only 34 out of a possible 164 services, according to the Federation on Tax Administration (See Appendix I for a list of Georgia's currently taxed services). The 45 states that levy a sales tax choose to place it on an average of 54 services. Georgia ranks 28th in the number of services taxed with Hawaii in the number one spot having 157 services taxed.¹² Georgia may recover the lost revenue by simply broadening the base to include currently exempt services without actually raising the tax rate.

In addition to raising revenues, expanding the sales tax to include services could nullify several disadvantages. Taxing services would reduce the horizontal inequity by subjecting purchasers of both goods and services to the sales tax. For example, if the sales tax extended to lawn services, a person purchasing the lawn service and the person purchasing a lawn mower would pay a required sales tax. Broadening the sales tax base would make it more stable and less susceptible to economic downturns. Finally, a sales tax on services would acknowledge the shift in Georgia's economy from goods to services.

Which services should be included in the sales tax base?

After excluding services such as healthcare, housing, education, legal, banking, public transit, insurance and financial services, there are 40 services that are purchased predominately by households (See Appendix II).¹³ Expanding the sales tax to household services avoids the pyramiding caused when taxing business-to-business purchases of goods or services.

Out of these 40 household services, Georgia already taxes 11 services (residential electricity, residential gas, diaper service, tuxedo rental, pari-mutuel racing admissions, amusement park admissions, bowling alleys, circus/fair admissions, cultural event admissions, professional sports

¹¹ Supra Note 6.

¹² Federation of Tax Administrators. "Sales Taxation of Services: 1996 Update," Research Report No. 147: April 1997.

¹³ Supra Note 4.

admissions, and private limousine services). Although the state is not the lowest in services taxed, there are many additional services that Georgia could tax such as:

- Towing charges
- Apparel repair/alteration
- Shoe repair
- Watch and jewelry repair
- Cable
- Club membership and dues
- Docking/landing fees
- Personal care services (i.e. haircuts, etc.)
- Interstate long distance phone
- Motor vehicle maintenance/repair
- Landscaping/lawn care

Revenue Impact

With the addition of these household services, Georgia could raise additional revenue of at least **\$600 million** *without* raising the sales tax rate.¹⁴

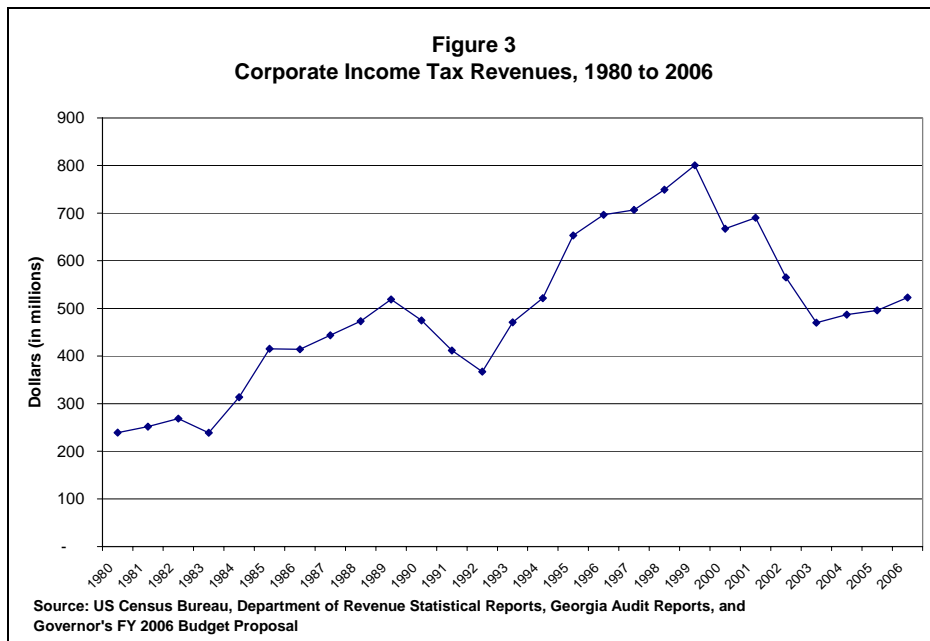
¹⁴ Analysis by the Institute on Taxation and Economic Policy: January 2005.

Corporate Income Tax

First enacted in 1929, the Georgia corporate income tax imposes a six-percent flat rate on the taxable income of domestic and foreign corporations doing business in Georgia. The tax rate has remained at six-percent since 1969 and is comparable to other Southeastern states.¹⁵ In recent years, corporate income tax revenue has declined significantly enough to spark considerable debate on whether to continue the corporate income tax at all. Rather than dissolve the corporate income tax, Georgia has the opportunity to strengthen the adequacy and fairness of the corporate income tax through the closure of two loopholes. The following discussion provides an overview of the tax's recent history as well as a justification for the corporate income tax in spite of its decline and policy options for its improvement.

Corporate Income Tax Decline

Nationwide, corporate tax revenues have declined in amount and as a share of personal income, revenues, and state product. Georgia has not escaped the erosion of this source of funds, as shown in Figure 3. Corporate income tax collections began decreasing after 1999, and continued to decline to a ten-year low in 2003.¹⁶ When calculated in constant dollars, the 2003 and 2004 collections were lower than any year since 1983. While the chart below suggests the cyclical nature of corporate tax collection, there has not been an increase in collections during the current recovery period similar to increases in past recoveries. The recovery since the 2001 recession, albeit sluggish, has not translated into a recovery for corporate income tax revenues. Projections for FY 2005 and FY 2006 show only a slight improvement to \$495 million and \$523 million.



¹⁵ For more information on the history and construction of corporate income taxes in Georgia see: Grace, Martin. "Georgia's Corporate Income and Net Worth Taxes." FRP Report No. 78. Georgia State University, Fiscal Research Center: December 2002;

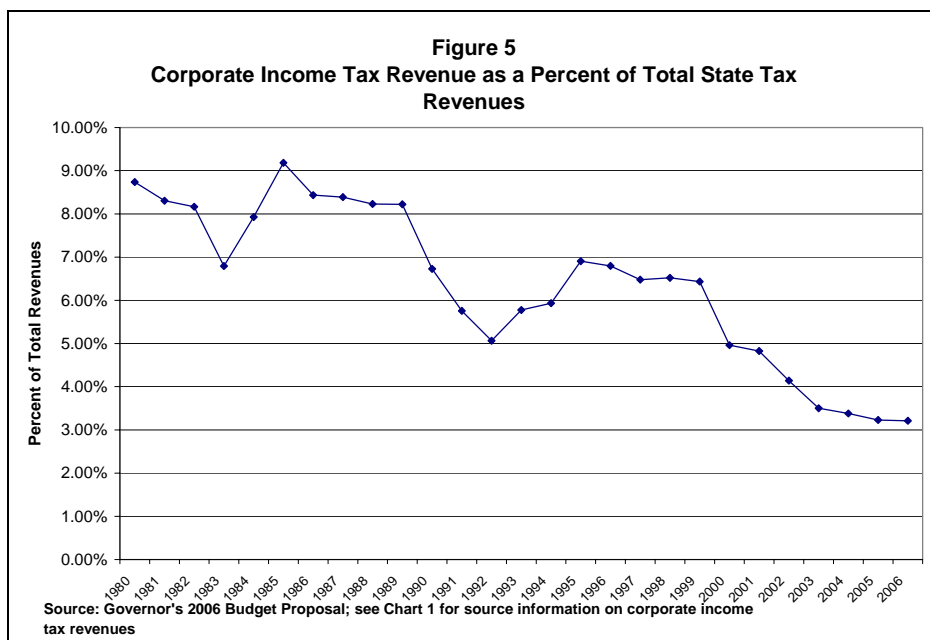
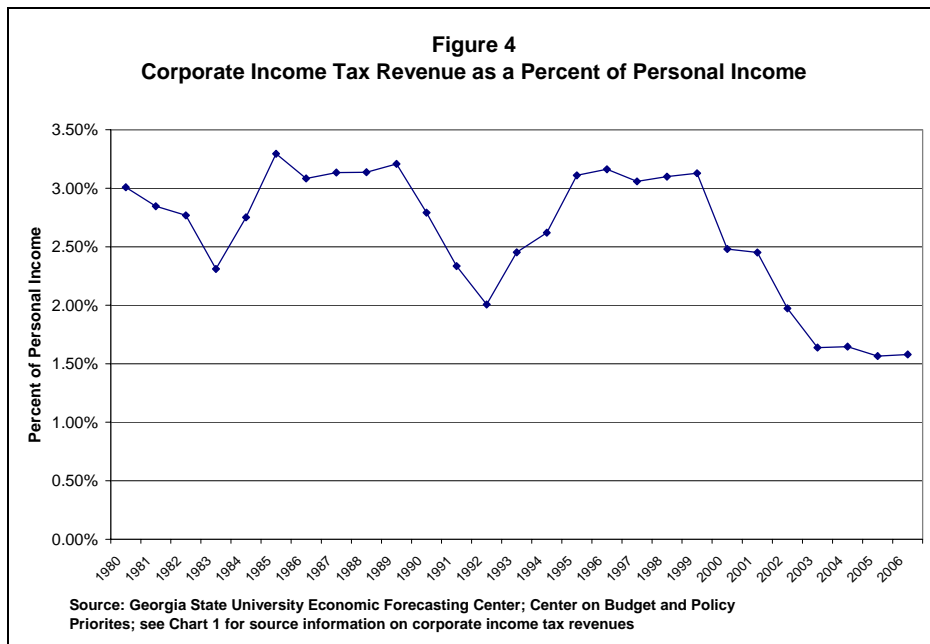
Wallace, Sally. "Trends in Corporate Income Tax Receipts." FRP Report No. 52. Georgia State University, Fiscal Research Center: December 2000.

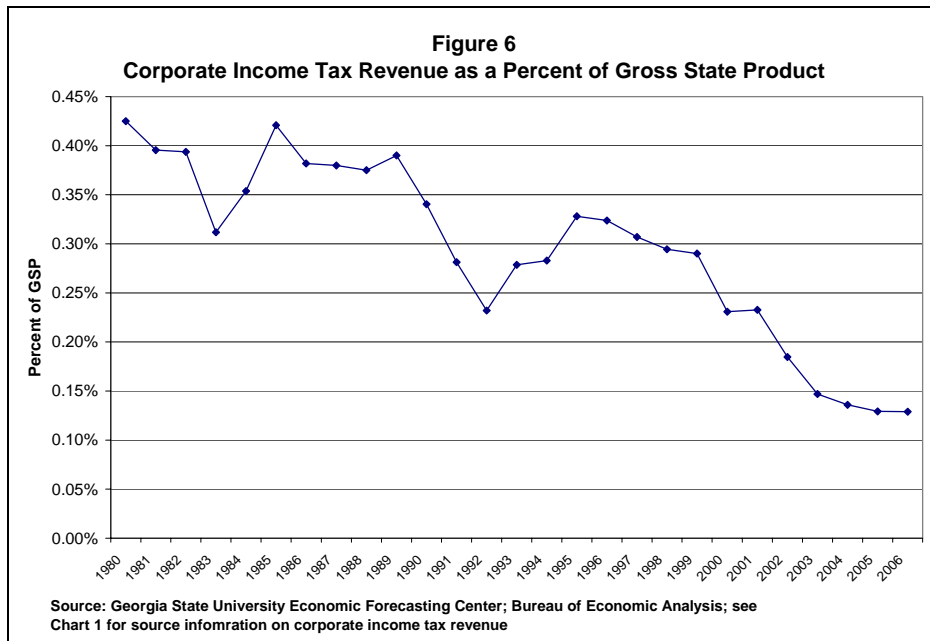
¹⁶ Data on corporate tax revenues come from several sources: US Census Bureau Census of Governments, Report of the State Auditor of Georgia, and Georgia Department of Revenue Statistical Reports. Forecasts of revenue collections are taken from the 2006 *Governor's Budget Report*. Forecasts of population, personal income, and gross state product are taken from: Dhawan, Rajeev. *Forecast of Georgia and Atlanta*. GSU Economic Forecasting Center. November 2004.

The decline of corporate tax revenue is also evident when viewing corporate taxes as a share of personal income, total tax revenue, and gross state product (GSP). For each comparison, corporate income tax revenues reached a record low in 2003 and 2004. (See Figures 4, 5, and 6.)

- As a share of personal income, corporate income taxes comprised 1.64% in 2003 and 1.65% in 2004. The average share from 1980 to 2002 was 2.8% of personal income.
- Corporate income taxes comprised 3.4% of total tax revenues in 2004, significantly lower than the 1980s and 1990s average of 7.2%.
- Finally, as a share of GSP, corporate taxes were 0.14% in 2004, down from 0.42% in 1980.

Based on forecasts of income, tax revenue, and population from the Georgia State University Economic Forecasting Center and the Governor's budget proposal, the diminishing 2003 and 2004 trends in corporate income tax as a percent of income, taxes, and GSP will continue in 2005 or 2006.





In addition to the declines in revenues, there has also been a decrease in the percent of corporations declaring taxable income. In fiscal year 2001, only 14.4% of corporate tax returns reported taxable income, a more than ten-percentage point decrease since 1990.¹⁷ Georgia appears to be following the national trend in declines of taxable income according to a recent study by the Citizens for Tax Justice and the Institute on Taxation and Economic Policy. The study reports that, nationally, of the 252 of the *Fortune 500* corporations examined for the study, state income taxes were paid on only one-third of their profits in 2003. The estimated cost of this tax avoidance by 252 corporations rose from \$11.9 billion in 2001 to \$16.5 billion in 2003.¹⁸

The causes for both the decline in collections and as a share of several measures are numerous, including changes in incorporation and the rise of tax credits and tax planning. Increasingly, companies are incorporating as S Corporations, which are not subject to corporate income tax. While C Corporations are subject to corporate income tax, S Corporations are taxed through shareholders' personal income taxes. Thus, a shift towards S Corporations produces a shift from the corporate income tax to the personal income tax system. Also, there has been an increase in the use of tax credits as an economic development strategy to lure new businesses to Georgia and assist growing establishments. As evidenced by Governor Perdue's current proposal to extend new tax credits to small businesses and strategic industries, this erosion of the corporate income tax through credits is likely to continue.¹⁹

Another strain on the corporate income tax in the coming years will arise if legislation such as HB 191, currently under review, changes the apportionment formula from a double-weighted sales formula to a single-sales factor formula. Originally, Georgia based corporate income taxes on an equal weighted formula of payroll, property, and sales. The income that was taxable, or apportioned, to Georgia was based on the portion of those three factors contained or produced in Georgia. In 1995, Georgia moved to a double-weighted sales formula in which sales accounts for 50% and payroll and property an equal 25% each. Current legislation (*HB 191*) proposes a further increase in the weighting of sales to a full single-sales factor formula by 2008. Under a single-sales factor formula, corporations with property and employees in Georgia, but with sales wholly outside of Georgia would not pay corporate

¹⁷ Graham, Bart L, Commissioner. *Georgia Department of Revenue Statistical Report*. 2003 and 1990.

¹⁸ McIntyre, Robert and Nguyen, T.D. Co. *State Corporate Income Taxes 2001-2003*. January 2005. Joint project of Citizens for Tax Justice and the Institute on Taxation and Economic Policy.

¹⁹ "Governor Perdue Focuses on Children, Jobs and Ethics During the State of the State Address." Press Release, January 12, 2005. www.gov.state.ga.us/press/2005/press662.shtml.

income tax to Georgia. “A single sales factor apportionment formula undercuts one of the fundamental rationales for a corporate income tax, which is that a corporation should pay taxes to a state as compensation for the benefits it receives from state services.”²⁰ While this formula has not been instituted and is not within the scope of this loophole discussion, it poses yet another threat to the viability of the corporate income tax and deserves attention.

While the granting of tax credits, the allowance of S Corporation structures, and even a move to single-sales apportionment can be argued as intentional tax strategies, there also exists an unintentional mechanism for the avoidance of corporate income tax in the form of corporate tax loopholes. These loopholes, known as passive investment corporations and nowhere income, allow corporations to escape corporate tax by shifting money throughout the states’ tax system. A discussion of these loopholes and ways to strengthen the tax through their closure follows, but first we must address whether the corporate income tax is fundamentally reasonable and worth strengthening.

Should We Save It?

With the notable decline in corporate income tax revenues and the varied causes for such decline, there is disagreement on the relevancy, or salvageability, of the tax. In spite of its current condition, however, there is extensive literature in defense of the corporate income tax as a necessary component of a good tax system. The most common justification for corporate income taxation is the benefit principle, which states that corporations should pay for the government services they use.²¹ Corporations rely on numerous services including roads, police and fire protection, courts, and other infrastructure. In essence, the state provides the marketplace and infrastructure necessary to produce and sell goods and services.²² Based on the benefit principle, corporations, much like individuals, should contribute to state government for the use of that infrastructure.

The continued value of the corporate tax is also demonstrated empirically as all states, except four, enact such a tax. Forty-six states have a form of the corporate income tax; and furthermore, many of those states are actively improving the tax through loophole closure. The other four states—Wyoming, Washington, South Dakota, and Nevada²³— have neither a corporate income tax nor a personal income tax. Instead, they rely heavily on other sources of taxation such as casinos or natural resource extraction. Some proponents of the corporate income tax claim that the existence of the corporate tax protects the personal income tax.²⁴ Without a corporate income tax, shareholders could escape some personal income tax liability by leaving profits or income in the untaxed corporations. The four states without a corporate income tax do not contend with this possibility since they do not tax personal income.

Corporate income taxation also diversifies the tax base, and thus makes the state somewhat less reliant on other major revenue sources. While the corporate income tax is small in comparison to revenue from the sales and personal income tax, it does offer a compliment to these taxes and raises much needed revenue. As a widely used tax that offers payment-for-services and tax base diversification, the corporate income tax is a basic element of our tax system and should be maintained.

²⁰ Mazerov, Michael. “The ‘Single-Sales Factor’ Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Give-away?” Center on Budget and Policy Priorities, Sept. 2001. www.cbpp.org/3-27-01sfp.pdf.

²¹ Extensive literature exists on the benefit principle of corporate taxation. For examples, see: Oakland, William H. and William A. Testa. *State-local business taxation and the benefits principle*. Federal Reserve Bank of Chicago. Vol. 20 No. 1, 1996; Pogue, Thomas F. *State Taxation of Business: Issues and Policy Options*. Westport, Conn.: Praeger, 1992.

²² McIntyre, Michael. “Thoughts on the Future of the State Corporate Income Tax.” *State Tax Notes*. Sept. 23, 2002. 931-947.

²³ South Dakota only imposes a tax on financial institutions.

²⁴ Brunori, David. “Stop Taxing Corporate Income.” *State Tax Notes*. July 1, 2002. 99-102.

Strengthening the Corporate Income Tax

If the main intention of the corporate income tax is to extract payment-for-services, then a decline in corporate income tax revenue can be viewed as a compliance issue in part. As mentioned previously, there are numerous causes for the decline in revenues, among them the use of corporate tax loopholes. These loopholes are a matter of compliance since corporations are escaping the intentions of the tax system. The strengthening of the corporate income tax is not the levying of a new tax, but rather the enforcement of the intentions of a long-standing tax in Georgia. It is apparent that Georgia is concerned with compliance as demonstrated by the Department of Revenue's (DOR) aggressive agenda of compliance enforcement. In recent budget hearings, DOR proposed hiring additional auditors to perform audits on out-of-state corporations. This compliance initiative could raise \$15 million. The closure of corporate tax loopholes could be an extension of these compliance measures by correcting the unintentional tax deficiencies currently weakening revenues.

The following discussion describes two corporate income tax loopholes as well as policy solutions to close those loopholes.²⁵

Passive Investment Companies

Corporations avoid paying taxes on certain types of income such as royalties by creating subsidiaries known as passive investment companies (PICs). By locating PICs in states that do not tax royalties and certain other types of income, corporations are able to shift income to these companies and avoid taxation in other states. For example, a hypothetical Georgia corporation, PeachCorp, can create a PIC in Delaware to hold its trademarks. When PeachCorp uses that trademark, it pays a fee to the PIC, and thus transfers income to the PIC. This income is now nontaxable income since Delaware does not tax royalties. In addition, the PIC shifts that income back to PeachCorp in the form of a loan. PeachCorp can deduct the interest of the PIC loan from its taxes, and further reduce its tax burden.

Solution: Combined Reporting

To stop the use of PICs, Georgia could require corporations to report on the profits of PICs along with their own profits in a combined corporate income tax return, a requirement known as combined reporting. Combined reporting not only addresses problems relating to PICs but to other income-transferring mechanisms as well. Combined reporting is a significant change to the corporate tax law, and should be studied carefully. It may be prudent to proceed combined reporting with legislation that only involves PICs rather than all income-transfer mechanisms.²⁶ States such as Alabama, Mississippi, North Carolina, and Ohio have enacted such legislation to address only PICs.

Nowhere Income

Nowhere income involves the apportionment of profits among states by multi-state corporations. Corporations must pay taxes to states in which they have a presence, but only after reaching a certain level of presence, or nexus. If the corporation does not reach that level of nexus, then the profits produced in that state become "nowhere income" since they are not subject to tax in any state.

Solution: Throwback Rule

States can correct for the problem of nowhere income by enacting the throwback rule. Under the throwback rule, the corporation's home state, or rather the production state, can tax the profits that

²⁵ This paper offers an introduction to two corporate tax loopholes. For a more detailed explanation of each loophole as well as information on other states' experience with these loopholes, see: Mazerov, Michael. "Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States." Center on Budget and Policy Priorities, Washington D.C.: May 23, 2003.

²⁶ Mazerov (2003).

are not taxed in the purchase state. The addition of the following clause to the tax code could correct for this loophole by extending the definition of gross receipts to include nowhere income:

“OR if the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and the taxpayer is not taxable in the State of the purchaser or the purchaser is the United States Government;”²⁷

Other states, including Alabama, Arkansas, Mississippi, and Missouri, have already included throwback rules to address this loophole.

Revenue Impact

Numerous states have already taken measures to close one or more of these loopholes, including several Southeastern states (Alabama, Arkansas, Mississippi, Missouri, North Carolina, Texas, and West Virginia).²⁸ By allowing corporations to use tax loopholes, Georgia experiences revenue loss. Closing the combined reporting corporate loophole would increase revenues by at least **\$500 million over ten years**.²⁹ Although there are no reliable estimates, closing the nowhere income corporate loophole would also substantially increase revenues. Recovering this lost revenue would improve the adequacy of public funds available to pay for services, and help to ensure that businesses are treated consistently. Closing these loopholes ensures compliance with the intentions of the corporate income tax and a more adequate investment from the business community.

²⁷ Interview with Michael Mazerov. January 2005.

²⁸ Mazerov, Michael. “Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States.” Center on Budget and Policy Priorities, Washington D.C.: May 23, 2003.

²⁹ Fiscal Note for House Bill 191 of the 2005 session of the Georgia General Assembly.

Conclusion

Expanding the sales tax base to include various household services and strengthening the corporate income tax to assure compliance through closing two loopholes brings fairness, equity, and economic reality to the current tax structure. Expanding the sales tax base to include services would do much to reverse the erosion of the sales tax by acknowledging the economic realities of the continued movement towards a service economy. The corporate income tax is a vital part of the overall tax structure and helps assure that those entities that benefit from government services contribute to help pay for such services. Closing corporate tax loopholes helps assure that compliance with the tax is fair and equitable.

In addition to the state's interest in developing a fair and equitable tax system that is sensitive to the modern economy, Georgia also has an interest in adequately funding services such as healthcare, education, public safety, and important social services such as child protection. Such services are vitally important to Georgia's economic development efforts. Expanding the sales tax base to include various household services and strengthening the corporate income tax would increase revenues by approximately \$800 million to \$1 billion without raising tax rates. An additional \$1 billion would still leave Georgia at a 20 year non-recession low in regards to revenues as a percent of personal income. The following table highlights the vital needs that could be funded with additional revenues.

Fully restore K-12 Education formula (QBE) austerity reductions. Such a restoration would help in the reduction of class sizes.	\$369 Million
Budget for Revenue Shortfall Reserve (RSR) – RSR currently contains \$51 million. A full RSR would contain \$725 million.	\$250 Million
1% additional pay raise for teachers and state employees to assure that salary increase equals inflation rate (3%)	\$75 Million
Partially restore Board of Regents austerity reductions (\$450 million) to avoid tuition increase.	\$75 Million
To assure "Olmstead" compliance, fund first year of five year plan developed by DHR and DCH to eliminate short-term and long-term planning list for Developmentally Disabled waivers (\$191 million).	\$21 Million
Restore FY 2006 proposed Medicaid cuts to hospitals.	\$21 Million
In order to recruit and retain foster parents, increase family foster care per diem rates to 75 percent of recommended daily cost to raise a child (\$21/day).	\$18 Million
Fully fund the Hazardous Waste Trust Fund and Solid Waste Trust Fund.	\$15 Million
To assure "Olmstead" compliance, fund first year of five year plan developed by DHR and DCH to eliminate Independent Care Waiver Program waiting list (\$53.6 million).	\$12 Million
Increase Funding to Public Health Departments by 10 percent.	\$14 Million
Adequately fund "Level of Care" to enable the state to purchase mental health services for those children within the child protective services system with the most comprehensive and expensive mental health needs.	\$13 Million
Restore cuts to PeachCare. Budget cuts have resulted in DCH implementing administrative rules that have resulted in 60,000 children losing health coverage for at least three months. Almost 14,000 children have lost coverage for longer than three months.	\$13 Million
Eliminate Community Care Services Program (CCSP) waiting list (1,732 slots). The CCSP program serves Medicaid eligible elderly Georgians in the community as opposed to nursing homes.	\$13 Million
Fill vacant State Trooper positions (120 state troopers)	\$10 Million
Double the Department of Economic Development "Tourism Marketing" budget.	\$ 6 Million.
TOTAL	\$925 Million

Expanding the sales tax to include services and closing corporate tax loopholes should be the first step in an overall tax reform effort. Comprehensive tax reform might include:

- Tax relief to working families through the broadening of the personal income tax brackets (which have not been changed since 1937), raising the personal exemption and standard deduction to the federal levels, as well as increasing the state low income tax credit.
- The review of various exemptions to the sales tax that have been put in place over the past 25 years. What are the policy reasons for the exemptions? Are such reasons still relevant? Are there less costly alternatives to accomplish the same policy goals? Such exemptions are costing the state treasury over \$725 million annually.
- The review of corporate tax credits. As budget expenditures made through the Department of Economic Development, the Department of Community Affairs, the Board of Regents, and the Department of Technical and Adult Education for economic development purposes are reviewed each year through the budget process, economic development tax expenditures that go directly to businesses and corporations need to be periodically reviewed. Are the tax breaks given to businesses as incentives to relocate to or expand in Georgia creating the high paying jobs with healthcare and retirement benefits that Georgia citizens need? How much do these tax credits cost? Are we getting our moneys worth?
- The review of the motor fuel tax. Georgia currently has the lowest gas tax rate in the country. Raising the motor fuel tax would help Georgia meet the growing transportation needs of rural and urban Georgia.
- The review of taxes on alcohol and tobacco. The use of such products leads to increased health care costs. Raising taxes on alcohol and tobacco would result in increased revenues to help defray the increased healthcare costs in the short run and lead to decreased use of such products with the corresponding decreased health care costs in the long run.

Budget reform and tax reform need to be linked. The Governor's budgeting philosophy of outcome and performance based budgeting should be discussed in the same conversation as tax reform.

- What should state government be doing?
- What are the policies needed to be successful?
- What will it cost to successfully implement such policies?

We then need to develop a fair and equitable tax system that will allow the state to raise the necessary revenues needed to accomplish the agreed upon policy goals.

Appendix I

Services Subject to Sales Tax in Georgia, 1996
Transportation Services
Income from intrastate transportation of persons Local transit (intra-city) buses Income from taxi operations
Utility Service - Industrial Use
Intrastate telephone and telegraph Cellular telephone services Electricity Water Natural gas Other fuel (including heating oil)
Utility Service - Residential use
Intrastate telephone and telegraph Cellular telephone services Electricity Natural gas Other fuel (including heating oil)
Services - Personal Services
Diaper service Income from funeral services Tuxedo rental
Business Services
Commercial linen supply Photo finishing Printing
Computer Services
Software - packaged or canned program Software - modifications to canned program Software - custom programs - material
Admissions and Amusements
Pari-mutuel racing events Amusement park admission and rides Billiard parlors Bowling alleys Circuses and fairs - admission and games Admission to cultural events Admission to professional sports events Rental of video tapes for home viewing
Leases and Rentals
Personal property, short term (generally) Personal property, long term (generally) Bulldozers, draglines and construction machinery, short term Bulldozers, draglines and construction machinery, long term Rental of hand tools to licensed contractors Short-term automobile rental Long-term automobile lease Limousine service (with driver) Aircraft rental to individual pilots, short term Aircraft rental to individual pilots, long term

Chartered flights (with pilot) Hotels, motels, lodging houses
Fabrication, Installation and Repair Services
Custom fabrication labor Repair material, generally Taxidermy
Use Tax on Services
Georgia does exempt sales of services sold to government entities. Georgia does exempt sales of services to federally chartered banks.
Additional Sales and Use Tax Information
Georgia does tax the gross receipts from tangible personal property rentals or leases. Georgia does tax shipping and delivery charges for tangible personal property.

Source: Federation of Tax Administrators, 1997.

Appendix II
State Sales Taxation of Selected Household Services
("T" = taxed)

	A L	A Z	A R	C A	C O	C T	D C	F L	G A	H I	I D	I L	I N	I A	K S	K Y	L A	M E	M D	M A	M I	M N	M S			
Veterinary services										T																
Horse boarding/training										T																
Pet grooming										T					T								T			
Landscaping/lawn care			T			T	T			T			T	T	T								T	T		
Self storage		T						T		T				T												
Marina services		T	T				T	T		T					T									T		
Residential electricity	T	T	T						T	T		T	T	T			T	T				T	T			
Residential gas	T	T	T						T	T		T	T	T			T					T	T			
Investment counseling										T					T											
Barber shops/salons										T					T											
Carpet/uphol. cleaning		T				T				T					T		T							T		
Dating services						T				T					T											
Diaper service	T	T							T	T			T	T	T		T							T		
Garment alter./repair						T	T	T		T					T	T	T							T		
Health clubs			T							T	T				T	T								T		
Laundry/dry cleaning							T			T					T	T	T		T					T	T	
Personal instruction						T				T																
Shoe repair			T			T	T	T		T					T	T	T					T		T		
Swimming pool clean.			T			T	T			T					T	T								T		
Tuxedo rental	T	T	T	T		T	T	T	T	T	T		T	T	T	T	T		T			T		T		
Exterminating						T		T		T	T				T	T								T	T	
Auto washing			T			T		T		T					T	T								T	T	
Auto road svc./towing										T					T	T									T	
Auto maint./painting			T			T	T	T		T					T	T	T							T	T	
Parking lots/garages		T	T			T	T	T		T					T		T							T	T	
Auto rustproofing		T	T			T	T	T		T					T	T	T							T	T	
Pari-mutuel racing adm.		T	T			T		T	T		T				T	T	T		T					T	T	
Amusement park adm.	T	T	T			T	T	T	T	T	T				T	T	T	T		T				T	T	
Bowling alleys	T	T	T			T		T	T	T	T				T	T		T						T	T	
Cable TV			T			T	T	T		T			T		T	T			T	T				T	T	
Circus/fair adm.	T	T	T			T	T	T	T	T	T				T	T	T	T		T				T	T	
Private club membersh.		T				T		T		T					T	T	T							T		
Cultural event adm.	T	T	T			T		T	T	T	T				T	T	T		T					T		
Prof. sports adm.	T	T	T			T	T	T	T	T	T				T	T	T	T		T				T	T	
Private limo svc.		T				T	T		T	T					T											
Labor chg., auto repair			T			T	T	T		T					T	T	T								T	
Labor chg., TV repair			T			T	T	T		T					T	T	T								T	
Labor chg., remodeling		T								T					T											
Extended svc. contracts			T	T	T	T	T	T		T	T	T			T	T	T								T	
Installation charges					T			T		T						T	T								T	T
# of these services taxed	9	18	22	2	2	25	18	22	11	39	10	3	6	34	27	6	20	2	8	0	4	24	21			

Source: Federation of Tax Administrators, *Sales Taxation of Services: 1996 Update*, Research Report No. 147 (Washington, DC: Federation of Tax Administrators), April 1997. Partially updated for known changes. Available at www.taxadmin.org/fta/pub/services/services.html.

M	N	N	N	N	N	N	N	O	O	P	R	S	S	T	T	U	V	V	W	W	W	W	
O	E	V	J	M	Y	C	D	H	K	A	I	C	D	N	X	T	T	A	A	V	I	Y	
				T									T										Veterinary services
					T								T	T						T			Horse boarding/training
T			T	T	T					T			T	T	T	T				T	T		Pet grooming
				T	T			T		T			T		T				T	T	T		Landscaping/lawn care
				T	T								T							T			Self storage
T			T	T	T			T		T			T	T		T			T	T	T	T	Marina services
	T			T		T							T			T				T	T	T	Residential electricity
T	T			T		T	T						T			T				T	T	T	Residential gas
				T									T										Investment counseling
				T									T										Barber shops/salons
				T						T			T	T	T					T	T		Carpet/uphol. cleaning.
				T	T								T		T				T	T			Dating services
	T			T		T		T				T	T	T	T	T		T	T	T		T	Diaper service
				T				T					T	T	T	T			T	T	T	T	Garment alter./repair
T	T			T				T				T	T	T	T		T			T	T		Health clubs
				T		T				T			T	T	T	T			T	T	T	T	Laundry/dry cleaning
				T									T							T			Personal instruction
				T				T					T	T	T	T			T	T	T	T	Shoe repair
			T	T	T			T					T		T				T	T	T		Swimming pool clean.
	T	T		T	T	T	T	T	T	T		T	T	T	T	T	T	T	T	T	T	T	Tuxedo rental
	T			T	T			T		T			T		T				T	T			Exterminating
	T			T	T			T		T			T	T		T			T	T	T	T	Auto washing
	T			T	T					T			T	T					T	T	T	T	Auto road svc./towing
	T			T	T			T		T			T	T		T			T	T	T	T	Auto maint./painting
				T	T				T				T	T	T				T	T	T		Parking lots/garages
	T	T		T	T			T		T			T	T		T			T	T	T	T	Auto rustproofing
T	T			T		T	T		T				T	T	T	T	T			T	T	T	Pari-mutuel racing adm.
T	T			T	T	T	T		T				T	T	T	T	T			T	T	T	Amusement park adm.
T	T			T			T		T				T	T	T	T	T		T	T	T		Bowling alleys
	T			T							T		T	T	T	T				T	T		Cable TV
T	T			T	T	T	T		T				T	T	T	T	T			T	T	T	Circus/fair adm.
T	T			T	T		T	T	T				T	T	T	T				T	T		Private club membersh.
T	T			T	T		T	T	T				T	T	T	T	T			T	T	T	Cultural event adm.
T	T			T	T	T	T		T				T	T	T		T	T		T	T	T	Prof. sports adm.
				T					T				T					T		T		T	Private limo svc.
				T	T	T		T		T			T	T		T			T	T	T	T	Labor chg., auto repair
				T	T	T		T		T			T	T	T	T			T	T	T	T	Labor chg., TV repair
				T	T	T							T		T				T	T			Labor chg., remodeling
	T			T	T			T		T			T	T	T	T		T	T	T	T		Extended svc. contracts
	T			T	T			T		T			T	T	T	T			T	T	T	T	Installation charges
11	20	2	17	39	23	10	9	17	10	15	1	12	40	27	24	22	10	4	21	37	29	21	#of these services taxed