AGG Authority ALERT

Georgia Adopts Advantageous Income Tax Treatment for Manufacturing, Sales & Service Companies

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House Bill 191, passed during Georgia's 2005 legislative session, significantly reduces the effective rate of Georgia income taxation of Georgia-based manufacturing, sales and service companies with substantial sales to customers outside Georgia. House Bill 191 amended Section 48-7-31 of the Georgia Code.

For all tax years beginning on or after January 1, 2008, manufacturing, sales and service companies doing business in Georgia will use a "Single Factor Gross Receipts" apportionment formula. This new method of apportionment results in a substantial reduction of Georgia income taxes for companies that manufacture products within the state of Georgia, sell goods from a Georgia base or render services from a Georgia base, but sell those products, goods or services to customers in other states. This change was designed to encourage manufacturing, distribution and service companies to invest or expand in Georgia.

The "Single Factor Gross Receipts" apportionment formula benefits manufacturing, distribution and service companies which conduct business in a number of states from a Georgia base in the following manner. Georgia only taxes a portion of the total income of a company that conducts its business in a number of different states. Under former law and through 2005, a manufacturing or sales company's total taxable income was "apportioned" to Georgia by multiplying that income by a fraction, computed as follows:

$$\frac{\dfrac{\text{Property Owned in Georgia}}{\text{Total Property Owned}} + \dfrac{\text{Payroll in Georgia}}{\text{Total Payroll}} + 2\text{x}\,\dfrac{\text{Georgia Gross Receipts}}{\text{Total Gross Receipts}}}{4}$$

Another way to calculate the part of total income apportioned to Georgia was to add the following three factors:

Property Factor	.25	x	$\dfrac{\text{Property in Georgia}}{\text{Total Property}}$
Payroll Factor	.25	x	$\dfrac{\text{Payroll in Georgia}}{\text{Total Payroll}}$
Sales Factor	.50	x	$\dfrac{\text{Georgia Gross Receipts}}{\text{Total Gross Receipts}}$

As indicated, under the old apportionment formula, each of the Property and Payroll factors had equal weight and the Gross Receipts factor had double weight in determining the portion of a manufacturing or sales company's income that was apportioned to, and therefore taxed by, the state of Georgia. The location of the Gross Receipts is generally determined by the destination to which shipment is made to a customer.

Under Georgia law prior to 1995, the income of a service company was required to "equitably" apportion their income to Georgia, but such companies were not required to use a particular formula to accomplish this apportionment. However, after 1995, service companies were and are still required to apportion their income to Georgia in the same manner as manufacturing or sales companies, unless such an apportionment "does not fairly represent the extent of the [service company's] business activity in Georgia." In that case, a service company can petition the Commissioner of Revenue to use a different formula.

Under the new apportionment formula, the Gross Receipts or sales element is the only factor used in determining the apportionment of a company's income to Georgia for tax years beginning on or after January 1, 2008. The appropriate apportionment fraction is now computed as follows:

$$\frac{\textbf{Georgia Gross Receipts}}{\textbf{Total Gross Receipts}}$$

As indicated by its name, under the new "Single Factor Gross Receipts" formula for the 2008 tax year and thereafter a company's Gross Receipts or sales factor is the only relevant factor in determining the portion of that company's income that is subject to Georgia income tax. For the 2008 tax year and thereafter, the formula ignores Georgia Property and Payroll.

The net result of this change is that companies with significant Georgia assets and Georgia payroll but substantial sales of goods or services to customers outside Georgia, now bear a proportionately smaller Georgia state income tax burden on manufacturing, sales and service income under the new formula than under Georgia's old three-factor apportionment formula. **Georgia now has a significantly lower effective rate of income tax for Georgia-based manufacturing, distribution or service companies which sell goods or services to customers outside Georgia**. An example will illustrate these advantages.

Example: Assume that, for the 2008 tax year, In-State Manufacturing Co., Inc. had the following total overall taxable income and the following percentages of Gross Receipts, Property, and Payroll within the state of Georgia:

Taxable Income:	$100 million
Percent of Property in Georgia:	100%
Percent of Payroll in Georgia:	100%
Percent of Gross Receipts in Georgia:	13%

Under the old formula, the following portion of In-State Manufacturing Co., Inc.'s income would be apportioned to Georgia:

Property Factor	.25	x	1	.25
Payroll Factor	.25	x	1	.25
Sales Factor	.5	x	.13	.065
Total				.565

Accordingly, $56.5 million (.565 x $100 million) of In-State Manufacturing Co., Inc.'s income would have been subject to Georgia income tax under the old formula. **Applying Georgia's 6% corporate income tax, the Georgia income tax would has been $3,390,000.**

Under the new formula, the following portion of In-State Manufacturing Co., Inc.'s income would be apportioned to Georgia:

Georgia Gross Receipts / Total Gross Receipts = .13

Accordingly, for the 2008 tax year, only $13 million (.13 x $100 million) of In-State Manufacturing Co., Inc.'s income would be subject to Georgia income tax under the new Single Factor Gross Receipts formula. **The Georgia income tax would be $ 780,000.**

Thus, in this example, the new formula results in $43.5 million less of In-State Manufacturing Co., Inc.'s income being subject to Georgia income tax and reduces its Georgia income tax by $ 2,610,000.

Because Georgia's corporate income tax is deductible in calculating In-State Manufacturing Company's taxable income for federal corporate income tax (generally 35%) purposes, the net effective tax savings under the Single Factor Gross Receipts formula would be approximately $ 1,696,500.

Under Georgia's new law, the result is the same for a manufacturing, distribution or service company.

This result is available under the new apportionment formula because, first, under long standing Georgia law, gross receipts are "sourced" by where the product or service will be used, or by the so-called "Marketplace" source rule. That is, if the customer will sell or use a product or service outside Georgia, the gross receipts from the sale of goods or services to that customer is not treated as a Georgia gross receipt in the allocation formula. Second, Georgia does not generally use the so-called "Throw Back Rule," under which many states tax income from sales of goods or services to out of state customers if the customer's state does not. Georgia does not generally tax such income.

Accordingly, if the state in which the goods or services are used does not tax the income attributable to those goods or services, that income will escape state income tax.

To illustrate the Throw Back Rule, assume a Service Company ("SERCO") based in State A (a state other than Georgia) sells services to a customer in State B and that State B does not attempt to tax SERCO on its income from sales in State B. Unfortunately, State A applies the Throw Back Rule to tax the income from sales of services in State B because State B did not do so. On the same facts, if Georgia were State A, Georgia would generally not tax income from sales of services to customers in State B even if State B does not tax income from such sales.

This change to a Single Factor Gross Receipts formula was phased in beginning with the 2006 tax year. For 2006, the Property and Payroll factors represented 10% of the fraction, and the Gross Receipts Factor represented 80% of the fraction. For 2007, the Property and Payroll Factors represented 5% of the fraction, and the Gross Receipts Factor represented 90% of the fraction.The apportionment formula (simplified) for the 2006 tax year was:

Property Factor	.1	x	<u>Georgia Property</u> Total Property
Payroll Factor	.1	x	<u>Georgia Payroll</u> Total Payroll
Sales Factor	.8	x	<u>Georgia Gross Receipts</u> Total Gross Receipts

The apportionment formula (simplified) for the 2007 tax year was:

Property Factor	.05	x	<u>Georgia Property</u> Total Property
Payroll Factor	.05	x	<u>Georgia Payroll</u> Total Payroll
Sales Factor	.9	x	<u>Georgia Gross Receipts</u> Total Gross Receipts

To summarize:

1. **Georgia's new Single Factor Gross Receipts apportionment formula has and will greatly reduce Georgia income tax on Georgia-based manufacturing, distribution and service companies that have out-of-Georgia sales. Beginning with the 2006 tax year, the phased in application of this new formula has significantly reduced Georgia's effective rate of income tax on Georgia companies that have sales outside Georgia.**

2. **Georgia is the first and only southeastern state to adopt the Since Factor Gross Receipts formula for all multistate businesses.**

3. **Other states may also adopt the Single Factor Gross Receipts formula for apportionment; however, if their source rules for Gross Receipts are more expansive than Georgia's, or if they use the Throw Back Rule, as described above, they will not offer income tax savings as large as those available under Georgia House Bill 191.**

If you have any questions about the matters discussed in this memorandum, please contact John L. Gornall, Jr., or John L. Brown:

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